



A REPORT  
TO THE  
MONTANA  
LEGISLATURE

FINANCIAL-COMPLIANCE AUDIT

# *Montana Board of Investments*

*For the Fiscal Year Ended  
June 30, 2018*

JANUARY 2019

LEGISLATIVE AUDIT  
DIVISION

18-04A

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**FINANCIAL-COMPLIANCE AUDITS**

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

The Single Audit Act Amendments of 1996 and the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards require the auditor to issue certain financial, internal control, and compliance reports in addition to those reports required by *Government Auditing Standards*. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2017, was issued March 23, 2018. The Single Audit Report for the two fiscal years ended June 30, 2019, will be issued by March 31, 2020.

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# LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors  
Cindy Jorgenson  
Joe Murray

January 2019

The Legislative Audit Committee  
of the Montana State Legislature:

This is our financial-compliance audit report of the Montana Board of Investments for the fiscal year ended June 30, 2018. The report includes the financial statements of the board's Unified Investment Program and the Enterprise Fund Program. The audit of these programs is required by the Montana Constitution and state law. Our audit work included analyzing the financial statements, note disclosures, and required supplementary information, as well as examining the underlying financial activity, and testing selected control systems. We also tested selected laws and regulations applicable to the board.

This report contains one recommendation to the board, related to internal controls over financial reporting. The board's written response to the audit recommendation is included in the audit report on page C-1. We thank the members of the board and their staff for their cooperation and assistance throughout the audit.

As discussed in the board's response on page C-1, the board concurs with the recommendation made in this report. However, the board and its consultant do not agree that the internal control deficiency over Enterprise Fund Statement of Cash Flows reporting is a material weakness. In our opinion, the \$696 million overstatement of individual amounts on the Enterprise Fund Statement of Cash Flows identified by audit staff constitutes a material misstatement, and the board's internal controls did not prevent, or detect and correct, it in a timely manner. Material misstatements, if undetected by the preparer, are indication of material weakness in internal controls. Our position, as reported on pages 10 and B-1, remains unchanged.

Respectfully submitted,

*/s/ Angus Maciver*

Angus Maciver  
Legislative Auditor



## TABLE OF CONTENTS

Figures and Tables.....	ii
Appointed and Administrative Officials .....	iii
Report Summary .....	S-1
<b>CHAPTER I – INTRODUCTION.....</b>	<b>1</b>
Introduction .....	1
Background.....	2
Prior Audit Recommendation .....	5
<b>CHAPTER II – FINDINGS AND RECOMMENDATIONS .....</b>	<b>7</b>
Internal Controls Over Financial Reporting.....	7
Statement of Cash Flows Reporting for the Enterprise Fund.....	7
Incomplete Note Disclosures.....	8
Summary .....	10
<b>INDEPENDENT AUDITOR’S REPORT AND UNIFIED INVESTMENT PROGRAM FINANCIAL STATEMENTS</b>	
Independent Auditor’s Report .....	A-1
Management’s Discussion and Analysis .....	A-5
Statement of Fiduciary Net Position for Fiscal Year Ending June 30, 2018.....	A-10
Statement of Changes in Fiduciary Net Position for Fiscal Year Ending June 30, 2018.....	A-11
Notes to the Financial Statements for the Fiscal Year Ended June 30, 2018 .....	A-12
<b>Supplementary Information</b>	
Combining Statement of Fiduciary Net Position .....	A-36
Combining Statement of Changes in Fiduciary Net Position .....	A-38
<b>INDEPENDENT AUDITOR’S REPORT AND ENTERPRISE FUND PROGRAM FINANCIAL STATEMENTS</b>	
Independent Auditor’s Report .....	A-43
Management’s Discussion and Analysis .....	A-46
Statement of Net Position as of June 30, 2018 .....	A-51
Statement of Revenues, Expenses, and Changes in Net Position for the Fiscal Year Ended June 30, 2018 .....	A-52
Statement of Cash Flows for the Year Ended June 30, 2018.....	A-53
Notes to the Financial Statements for the Fiscal Year Ended June 30, 2018 .....	A-55
Required Supplementary Information .....	A-73
<b>REPORT ON INTERNAL CONTROL AND COMPLIANCE</b>	
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i> .....	B-1
<b>BOARD RESPONSE</b>	
Montana Board of Investments .....	C-1

## FIGURES AND TABLES

### Figures

Figure 1	Total Investments Managed by Pool and Separately Managed Investments (SMI).....	3
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### Tables

Table 1	Pool and Investments by Type–June 30, 2018 .....	4
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## APPOINTED AND ADMINISTRATIVE OFFICIALS

			<u>Term Expires</u> <u>January 1</u>
<b>Montana Board of Investments</b>	Mark Noennig, Chairman	Billings	2021
	Karl Englund, Vice Chair	Missoula	2019
	Teresa Olcott Cohea	Helena	2019
	Diane Fladmo	Helena	2019
	Jack Prothero	Great Falls	2021
	Jeffery Greenfield	Shepherd	2021
	Jon Satre	Helena	2019
	Maggie Peterson	Anaconda	2021
	Jim Edwards	Helena	2021
	Scott Sales	Senate Liaison	
	Jim Hamilton	House of Representatives Liaison	

**Administrative Officials** Dan Villa, Executive Director (effective October 2018)  
David Ewer, Executive Director (through September 2018)  
Geri Burton, Deputy Director (through November 2018)  
Joe Cullen, Chief Investment Officer  
Julie Feldman, Financial Manager

For additional information concerning the Montana Board of Investments, contact:

Dan Villa, Executive Director  
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Helena, MT 59620-0126  
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# MONTANA LEGISLATIVE AUDIT DIVISION

## FINANCIAL-COMPLIANCE AUDIT

### Montana Board of Investments

For the Fiscal Year Ended June 30, 2018

JANUARY 2019

18-04A

REPORT SUMMARY

The Montana Board of Investments managed a combined \$18.6 billion of investments for state entities and local governments as of June 30, 2018. Additionally, the board had approximately \$105 million in bonds payable and \$81 million in loans receivable, excluding interest, as of June 30, 2018, associated with the Intermediate Term Capital loan program. Our audit work over the board's financial statements identified deficiencies in internal controls over financial reporting, resulting in incomplete note disclosures and errors in reported cash flows approximating \$696 million. This report contains a recommendation related to these control deficiencies.

### Context

Article VIII, Section 13 of the Montana Constitution requires the Legislature to provide for a Unified Investment Program (UIP) for public funds, and §17-6-201, MCA, requires the Montana Board of Investments (board) to administer the program. The board has sole authority to invest public retirement system funds and state compensation insurance fund assets, in accordance with state law and the Montana Constitution. In addition, the board manages the investments of state agencies and certain local governments, such as cities, counties, and school districts.

To manage the UIP, the board has created three investment pools that operate similarly to mutual funds. State agencies and local governments may participate in two of the pools, provided they meet the requirements for participation. The state's retirement systems are the only eligible participants for the third pool. The board also manages direct investments for eligible state agencies, including the investments of the Montana State Fund.

As of, and for the fiscal year ended June 30, 2018, the board managed approximately \$18.6 billion of investments in the UIP.

Approximately 60 percent of those investments were in the Consolidated Asset Pension Pool (CAPP), which holds investments exclusively for the Teachers and Public Employees Retirement Systems. Additionally, the board distributed approximately \$182.3 million in income to participants of the Short-Term Investment Pool (STIP), Trust Funds Investment Pool (TFIP), and Separately Managed Investments (SMI). CAPP does not distribute income to participants. The fair value of investments managed through the UIP increased approximately \$770.2 million from June 30, 2017, to June 30, 2018.

The board also administers the state's Economic Development Bond Act (EDB) and Municipal Finance Consolidation Act (MFC) programs, which comprise the Enterprise Fund Program. Under the MFC Act, the board is authorized to issue up to \$190 million in bonds. The proceeds of the Intermediate Term Capital (INTERCAP) bonds issued under the MFC are loaned to eligible Montana governments to finance capital improvements or other needs as authorized by law. The board makes firm commitments to fund loans through the INTERCAP program. At June 30, 2018, the

*(continued on back)*

board had approximately \$105 million in bonds payable and \$81 million in loans receivable for the INTERCAP program. Additionally, the board had \$38 million in outstanding INTERCAP loan commitments as of the end of fiscal year 2018.

In addition to the INTERCAP program, under both the MFC and EDB acts, the board is authorized to provide governments with access to financing through the issuance of conduit (no-commitment) debt. Assets and revenues of the borrowers are pledged to repay the debt. Because the board has no obligation for this debt, the bonds are not reflected on the Enterprise Fund Program financial statements. They are, however, disclosed in the notes. At June 30, 2018, the total conduit debt outstanding under the MFC Act was \$10.1 million, and there was no debt outstanding under the EDB Act.

## Results

The Montana Constitution and state law require annual audits of the board. The board issues separate financial statements for the UIP and Enterprise Fund Program. Our audit work included analyzing the financial statements, note disclosures, and required supplementary information, as well as examining the underlying financial activity and tying it to support from external parties, for both programs. Our work also included testing selected control systems and state laws related to the programs.

We also followed up on the recommendation made in the prior audit report, related to a material weakness in internal controls over financial reporting. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of

performing their assigned functions, to prevent, or detect and correct, misstatements in a timely basis. As part of the current audit, we considered the steps the board took to address the deficiency identified during the prior audit, and the effectiveness of those steps. Through our audit work, we noted the steps resulted in improvements in financial reporting, as measured by a decrease in the number of significant errors we identified and communicated on the current audit as compared to the prior audit.

However, our audit procedures also identified errors in financial reporting for fiscal year 2018, including errors in cash flow reporting for the Enterprise Fund Program and incomplete note disclosures for both programs. As such, this report contains one recommendation to the board related to internal controls over financial reporting.

Recommendation Concurrence	
Concur	1
Partially Concur	0
Do Not Concur	0
<b>Source: Agency audit response included in final report.</b>	

# Chapter I – Introduction

## **Introduction**

We performed a financial-compliance audit of the Montana Board of Investments (board) for the fiscal year ended June 30, 2018. The objectives of the audit were to:

1. Obtain an understanding of the board's internal control systems to the extent necessary to support our audit of the financial statements, and, if appropriate, make recommendations for improvements in management and internal controls of the board.
2. Determine whether the board's Unified Investment Program financial statements present fairly the fiduciary net position and the changes in fiduciary net position of the program for the fiscal year ended June 30, 2018.
3. Determine whether the board's Enterprise Fund Program financial statements present fairly the net position, changes in net position, and cash flows of the program for the fiscal year ended June 30, 2018.
4. Determine whether the board complied with selected state laws and regulations during the audit period.
5. Determine the implementation status of the prior audit recommendation.

Our audit efforts over the board's Unified Investment Program (UIP) focused primarily on cash and cash equivalent and investment balances, as well as purchases and sales by participants, the net change in fair value of investments, dividend and interest income, and income distributions to participants. We analyzed the financial statements, note disclosures, and required supplementary information, as well as examined the underlying financial activity. As part of this work, we compared investment-related transactions and balances recorded by the board to the reports of its custodial bank, which is charged with the safekeeping of the investment assets. In this role, the bank settles purchases and sales of securities, collects information regarding the assets and related income, and provides information and support to the board for its administration of the UIP. We also tested selected control systems and state laws related to the program.

Our audit efforts over the board's Enterprise Fund Program focused primarily on cash and cash equivalent, investment, notes and loans receivable, and bonds payable balances and their related cash flows. We also analyzed the financial statements, note disclosures, and required supplementary information, as well as examined the underlying financial activity. As part of this work, we performed testing on a sample of new loans issued during the audit period. We also tested selected control systems and state laws related to the program.

The report includes one recommendation related to internal controls over financial reporting.

## **Background**

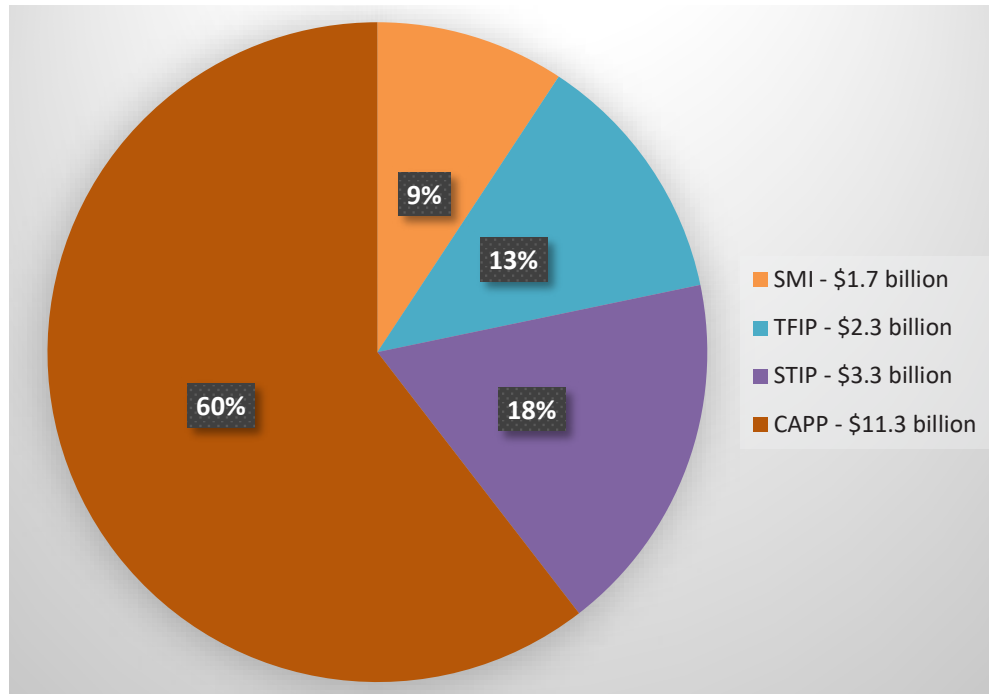
The board is allocated to the Department of Commerce for administrative purposes. The board employs an executive director and chief investment officer who in turn hire and manage staff. The staff members advise the board, implement board decisions, and perform daily investment, loan management, and record-keeping functions.

To manage the UIP, the board has created investment pools that operate similarly to mutual funds. The board establishes investment policies for each pool, outlining the investment strategy for the pools. The board's objectives for each of the pools, as well as information on the pool participants, are presented below.

- ♦ Short-Term Investment Pool (STIP): The pool is designed to achieve a high level of management income that is compatible with the preservation of principal, providing participants with liquidity with one-day notification. State agencies, the state's retirement systems, and local governments are eligible to participate in STIP.
- ♦ Trust Funds Investment Pool (TFIP): The pool is designed to provide participants exposure to a portfolio of diversified income-producing assets. State agencies and local governments meeting eligibility criteria may participate in TFIP.
- ♦ Consolidated Asset Pension Pool (CAPP): The pool is designed to achieve a high level of investment performance that is compatible with its risk tolerance and prudent investment practices. The board maintains a long-term perspective in formulating and implementing investment policies for the pool, and in evaluating investment performance within the pool. CAPP participants are limited to the state's retirement systems. CAPP was established in fiscal year 2017, by consolidating the five pools previously used to manage pension investments into a single pool.

In addition to these pools, the board manages direct investments in fixed income securities, equity index funds, and commercial loans for approximately 20 state agencies. These investments are reported collectively in the board's UIP financial statements as Separately Managed Investments (SMI). Figure 1 and Table 1 on pages 3 and 4 present information on the investments managed in the pools and SMI at June 30, 2018. For more information on the investments managed by the board, refer to the note disclosures beginning on page A-12.

Figure 1  
**Total Investments Managed by Pool and Separately Managed Investments (SMI)**  
June 30, 2018



Source: Compiled by the Legislative Audit Division based on board accounting records.

Table 1  
**Pool and Investments by Type—June 30, 2018**  
(in thousands)

	STIP*	TFIP	CAPP	SMI
Cash and Cash Equivalents			\$334,649	
STIP		\$30,833	\$80,323	
Fixed Income Investments	\$3,190,706	\$2,163,699	\$2,265,508	\$1,283,959
Money Market Funds	\$140,519			
Domestic Equity Investments			\$4,074,120	
International Equity Investments			\$1,309,739	
Comingled Equity Index Funds			\$936,139	\$180,026
Direct Real Estate Holdings			\$19,185	
Mortgages and Loans			\$3,861	\$180,618
Private Equity Partnerships			\$1,365,239	
Core Real Estate Partnerships		\$138,538	\$329,903	\$88,909
Non-Core Real Estate Partnerships			\$396,524	
Timber Partnerships			\$110,153	
<b>Total</b>	<b>\$3,331,225</b>	<b>\$2,333,070</b>	<b>\$11,315,343</b>	<b>\$1,733,512</b>

**Source: Compiled by the Legislative Audit Division based on board records.**

\* Some of the investments in STIP meet the definition of cash and cash equivalents, but are presented by type of investment for greater detail.

The board also administers the state's Economic Development Bond Act (EDB) and Municipal Finance Consolidation Act (MFC) programs, which comprise the Enterprise Fund Program. Under the MFC Act, the board is authorized to issue up to \$190 million in bonds. The board's Intermediate Term Capital Program (INTERCAP) bonds, issued under the MFC, are used to provide loans to eligible Montana governments to finance capital expenditures for up to 15 years. Under the MFC and EDB programs, the board also provides eligible Montana governments with access to financing through the issuance of conduit (no-commitment) debt. Assets and revenues of the borrower are pledged to repay the debt. Because the board has no obligation for this debt, the bond issues are not reflected on the board's Enterprise Fund Program financial statements but are disclosed in the notes.

The board publishes an annual report detailing the UIP and Enterprise Fund Program activity for the year. This report is available on the board's website or by contacting the board.

### **Prior Audit Recommendation**

The prior audit for the fiscal year ended June 30, 2017, contained one recommendation to the board related to a material weakness in internal controls over financial reporting for both the UIP and Enterprise Fund Program. The recommendation related to updating procedures for preparing and reviewing the financial statements. For the UIP, this included updating procedures to reflect the current pool structure and included an independent review of the statements by staff knowledgeable with program operations and Generally Accepted Accounting Principles (GAAP). For the Enterprise Fund Program, this involved updating procedures to include review of requirements in generally accepted accounting principles for new program activity. This recommendation is partially implemented.

For both programs, board staff used detailed checklists to ensure all pieces of the financial statements were completed and reviewed by separate staff members. For the UIP financial statements, this checklist included detail for the new pool structure implemented in fiscal year 2017. In addition to a review by board staff, the board contracted with an independent consultant, knowledgeable in GAAP, to perform a review of the programs' financial statements.

We noted these steps resulted in improvements in financial reporting, as measured by a decrease in the number of significant errors we identified and communicated during the current audit as compared to the prior audit. However, the results of the current audit indicate a continued need for improvement in internal controls to ensure complete and accurate financial reporting. Refer to the Findings and Recommendations starting on page 7 of the report for more information about the internal control deficiencies identified in the current audit.





## Chapter II – Findings and Recommendations

### **Internal Controls Over Financial Reporting**

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**The Montana Board of Investments’ internal controls did not ensure complete and accurate financial reporting for fiscal year 2018.**

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The Montana Board of Investments (board) administers the state’s Unified Investment Program (UIP), as well as the state’s Economic Development Bonds Act (EDB) and Municipal Finance Consolidation Act (MFC) programs. The EDB and MFC programs are collectively referred to by the board, and throughout our report, as the Enterprise Fund Program. State law requires the board to follow Generally Accepted Accounting Principles (GAAP) for the accounting and financial reporting for the UIP and Enterprise Fund programs. Additionally, state accounting policy requires management of the board to establish internal control policies and procedures designed to ensure the accuracy and reliability of financial data, such as the financial statements and note disclosures prepared for each of the programs.

As discussed on page 5, our prior audit of the board identified a material weakness in internal controls over financial reporting. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements in a timely basis. As part of the current audit, we considered the steps the board took to address the deficiency identified during the prior audit, as outlined on page 5. Through our audit work, we noted these steps resulted in improvements in financial reporting, as measured by a decrease in the number of significant errors we identified and communicated on the current audit as compared to the prior audit.

However, our audit procedures also identified errors in financial reporting for fiscal year 2018, including errors in cash flow reporting for the Enterprise Fund Program and incomplete note disclosures for both programs. At the root of these errors was an incomplete application or consideration of all GAAP requirements when changes in program operations or in financial reporting are implemented. The board’s internal controls can be improved by ensuring staff consider all relevant and applicable GAAP guidance when changes occur or are contemplated. More information on the errors indicative of deficiencies in internal control is presented in the following two sections.

### **Statement of Cash Flows Reporting for the Enterprise Fund**

In March 2017, the board began investing Enterprise Fund Program money more heavily in United States Treasuries with a short time frame between purchase and

maturity to obtain a better yield on investments. Under GAAP, these types of investments meet the definition of cash equivalents for financial reporting purposes because they are short-term, highly-liquid, readily convertible to cash, and so near their maturity date they contain insignificant risk that interest rate changes will impact their values. Board staff identified the implication this change in investment strategy would have on presenting investment activity on the face of the Statement of Net Position, and appropriately classified a majority of these investments as cash equivalents at June 30, 2018.

Staff did not, however, accurately apply GAAP requirements associated with these types of investments for Statement of Cash Flows reporting purposes. Under GAAP, the cash inflows and outflows associated with purchases and sales of cash equivalents should not be included on the statement of cash flows. Purchases and sales of cash equivalents are part of the entity's cash management activities, rather than the operating, capital, investing, and financing activities the Statement of Cash Flows is intended to report. Contrary to this guidance, board staff included approximately \$696 million of cash inflows and outflows related to sales and purchases of cash equivalents on the draft Enterprise Fund Program Statement of Cash Flows provided as part of the audit. Board staff were not aware of the GAAP requirements or the errors until we brought them to their attention.

### **Incomplete Note Disclosures**

As noted on page 5, in response to the recommendation in the prior audit, the board hired a contractor knowledgeable in GAAP to review the draft financial statements for both the UIP and Enterprise Fund programs. Board staff considered the suggestions and recommendations made by the contractor, and made changes in accounting and financial reporting related to those changes if staff determined the suggestions were reasonable. Board staff also made other changes independently from the suggestions of the contractor. As part of the audit, we considered whether the changes made by board staff were reasonable under GAAP.

Through this work, we determined several of the changes were reasonable, and took no exception to them. However, we also identified the following items considered to be unreasonable.

- ♦ **Missing Disclosure of a Change in Accounting Principle**

Under GAAP, there is a presumption that once adopted, an accounting principle, or a government's application of that accounting principle, should be consistently applied. The consistent use of accounting principles from one period to another enhances the utility of financial statements by facilitating analysis and understanding of comparative accounting data. Because of this presumption, if a government chooses to change an accounting principle, or how they apply a principle, GAAP requires disclosure of the change,

including the reason for making the change and how the change results in preferable financial reporting.

During fiscal year 2018, board staff determined the approximate \$2.59 billion and \$24.01 million in cash equivalents of the UIP and Enterprise Fund programs, respectively, should be reported at cost. The board had previously reported a majority of the cash equivalents for these programs at fair value. Board staff indicated, and we confirmed as part of the audit, that there is not a significant difference in the valuation of the cash equivalents under cost or fair value. This is due to the types of investments held as cash equivalents and the short period of time that exists between purchase and maturity. GAAP allows for the types of investments underlying the cash equivalents at June 30, 2018, to be reported at cost, so we did not take exception to the change in valuation approach.

However, this type of change in valuation constitutes a change in accounting principle requiring disclosure under GAAP. Board staff did not consider the need to disclose the change in accounting principle in the draft note disclosures provided as part of the audit. While the change does not have a significant impact on the dollar amounts presented on the Enterprise Fund Program Statement of Net Position and the UIP Statement of Fiduciary Net Position, the change does significantly change the amount of investments over which fair values are disclosed. To comply with GAAP, and to ensure understandability of the financial statements and note disclosures, the board should have disclosed the change.

◆ **Incomplete Credit Risk Disclosures**

GAAP identifies certain risks associated with investments, and requires governments to present information on investment risks in their note disclosures. For financial reporting for fiscal year 2018, board staff removed certain investment risk disclosures for the UIP and Enterprise Fund programs investments classified as cash equivalents. While we found removal of some of the risk disclosures to be reasonable, based on the nature of the investments and the guidance in GAAP, we also determined the board incorrectly removed credit risk disclosures for several of the cash equivalents in the UIP.

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligations. GAAP stipulates governments should provide information about the credit risk associated with their investments by disclosing the credit quality ratings of investments in debt securities, external investment pools, money market funds, bond mutual funds, and other pooled investments of fixed-income securities. GAAP provides an exception to these disclosure requirements for obligations of or explicitly guaranteed by the U.S. government.

For the Enterprise Fund, nearly all the cash equivalents are U.S. Treasuries. As such, we did not take exception to removal of the credit risk disclosures for cash equivalents of the Enterprise Fund Program. For the UIP, however, credit risk applies to approximately \$1.86 billion of the investments underlying the reported cash equivalents. Under GAAP, the board should have disclosed credit risk for these investments. Board staff indicated they

believed the investments had little credit risk exposure, based on the short time between purchase to maturity and the level of scrutiny and due diligence investment staff perform before purchasing investments. Additionally, staff indicated the board had not suffered a loss event as of the audit opinion date on the cash equivalents as of June 30, so they did not consider the risk disclosure necessary. GAAP does not support excluding the disclosures for these reasons, and accordingly, the disclosures should not have been removed for the UIP.

## **Summary**

We communicated the errors in financial reporting outlined in the prior sections to board staff as part of the audit, and staff made the necessary financial statement and note disclosure adjustments to correct the errors. Accordingly, the financial statements and note disclosures presented in this report are accurate in all material respects. While the board corrected the errors, the board's internal control procedures should be enhanced to allow management to prevent, or detect and correct, these types of errors prior to our office's audit of the documents.

Auditing standards require us to consider whether control deficiencies identified during an audit rise to the level of significant deficiencies or material weaknesses, and provide the following definitions:

- ♦ **Material Weakness:** A deficiency in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.
- ♦ **Significant Deficiency:** A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

For the Enterprise Fund program, we consider the control deficiency, as it relates to the statement of cash flow reporting, to be a material weakness in internal control. The board's procedures for preparing and reviewing the financial statements did not prevent, or detect and correct, approximately \$696 million in overstatements of cash inflows and outflows. We consider these overstatements to be material.

For the Enterprise Fund Program and UIP note disclosures, because we do not believe the errors previously discussed would negatively impact a reader's decision making, we have not elevated the deficiency to a material weakness. However, we believe the deficiency merits the attention of those charged with governance of the board.

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**RECOMMENDATION #1**

*We recommend the Montana Board of Investments enhance internal controls over financial reporting to ensure staff consider and apply all relevant Generally Accepted Accounting Principles when implementing changes with a financial reporting impact.*

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# **Independent Auditor's Report and Unified Investment Program Financial Statements**





## LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors  
Cindy Jorgenson  
Joe Murray

## INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

### *Introduction*

We have audited the accompanying Statement of Fiduciary Net Position of the Montana Board of Investments' (board) Unified Investment Program as of June 30, 2018, the related Statement Changes in Fiduciary Net Position for the fiscal year then ended, and the related notes to the financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this responsibility includes designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the board's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the board's internal control, and accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana Board of Investments' Unified Investment Program as of June 30, 2018, and the changes in fiduciary net position for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

### *Emphasis of Matters*

As discussed on page A-12 in the notes to the financial statements, the Montana Board of Investments' Unified Investment Program financial statements are intended to present the financial position and changes in financial position of only the portion of the financial reporting entity of the state of Montana that are attributed to the transactions of the Unified Investment Program at the board. They do not purport to, and do not present fairly the financial position of the state of Montana as of June 30, 2018, or the changes in its financial position and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

As discussed on page A-15, in fiscal year 2018, the Montana Board of Investments elected to change its method of valuing cash equivalents, from fair value to cost. As a result of this change, the amount of activity disclosed in the fair value note disclosures is different than that of prior years. Our opinion is not modified with respect to this matter.

### *Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on page A-5 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

*Supplementary Information*

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The Combining Statement of Fiduciary Net Position on pages A-36 and A-37 and the Combining Statement of Changes in Fiduciary Net Position on pages A-38 and A-39 are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

*Other Reporting Required by Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 7, 2018, on our consideration of the Montana Board of Investments' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the board's internal control over financial reporting and compliance.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA  
Deputy Legislative Auditor  
Helena, MT

December 7, 2018



## MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis for the Unified Investment Program (UIP) of the Board of Investments (the Board) of the State of Montana, (the State), is presented as an introduction to the financial statements of the UIP. It is meant to assist the reader in understanding the financial statements by providing an overall review of the financial activities during the year, as well as to provide a comparison to the prior year's activities and results.

In addition to the UIP, the Board also administers an Enterprise Fund to account for its programs created by the Municipal Finance Consolidation Act and the Economic Development Bond Act. This section of the report represents only the UIP. The Enterprise Fund financial statements are presented separately.

### Financial Highlights

The fiduciary net position of the UIP increased to approximately \$18.6 billion in comparison to a beginning fiduciary net position of approximately \$17.7 billion, as restated. With respect to the underlying components of the UIP: Consolidated Asset Pension Pool (CAPP) had a meaningful positive increase primarily due to equity-related investments producing strong investment returns, the Trust Funds Investment Pool (TFIP) had a slight positive increase due to fixed income valuations, the Short Term Investment Pool (STIP) increase in value was primarily driven by the contribution of additional capital into the pool, and the Separately Managed Investments (SMI) had a small positive increase in the investment valuation, but this was entirely offset and more, by the participants experiencing greater cash outflows than inflows. Below is a summary of the Change in Net Position by pool and SMI from the prior to current fiscal year:

<b>Change in Fiduciary Net Position for Pool and SMI participants (in thousands)</b>	<b><u>For the Fiscal Year Ended June 30, 2018</u></b>
Consolidated Asset Pension Pool (CAPP)	\$ 671,765
Trust Funds Investment Pool (TFIP)	5,840
Short Term Investment Pool (STIP)	343,306
STIP included in investment pools	45,976
Separately Managed Investments (SMI)	<u>(124,632)</u>
<b>Total Net Change in Net Position by Pool and SMI Participants</b>	<b><u>\$ 942,255</u></b>

The investment return of UIP is best characterized by describing the investment returns of the underlying pools.

	1-Year Total Return
CAPP	9.0%
TFIP	0.3%
STIP	1.5%

The investment returns are based on data made available by the custodial bank. Performance calculations were prepared using time-weighted rates of return and are net-of-fees. SMI investment returns vary depending on the accounts specific investment allocations and the cash flows in and out of the account during the period.

### Overview of the Financial Statements

The UIP is comprised of a combination of one internal investment pool, two external investment pools and the SMI to meet the financial goals and expectations of the state and local government agencies and entities which entrust these funds to the Board. The amounts reported within these financial statements become part of the governmental,

proprietary and fiduciary fund categories of the State's Comprehensive Annual Financial Report (CAFR), which is separately issued from these financial statements. The three pools and SMI are contained within the UIP. The CAPP is an internal investment pool, and TFIP and STIP are external investment pools.

As of June 30<sup>th</sup>, the Board separately managed investments outside of the pools on behalf of 16 participants. The investments are combined for reporting purposes in the SMI portion of the UIP. In previous financial statements, the SMI portion of the UIP was referred to as All Other Funds (AOF). SMI participants include the State Treasurer's Cash Fund, state agency insurance reserves and other state agencies. SMI participation is at the discretion of the Board staff for state agencies allowed to participate in the UIP.

The financial statements and footnotes follow this section of the report. The **Statement of Fiduciary Net Position** provides information on the types of investments, other assets, and liabilities of the pools and SMI previously mentioned, as of the fiscal year ended June 30, 2018.

The **Statement of Changes in Fiduciary Net Position** provides information on investment performance and other increases (additions) and decreases (deductions) in the fiduciary net position of the pools and SMI, for the fiscal year ended June 30, 2018. The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America (GAAP) as established by the Governmental Accounting Standards Board (GASB).

The **Notes to the Financial Statements** provide additional information that is essential to a full understanding of the data provided in the financial statements of the UIP. Additional supplementary information is presented which is not required by GAAP. Such information includes combining statements for transparency.

### Financial Analysis

*Fiduciary Net Position.* The fiduciary net position is the accumulated excess of assets over liabilities from the inception of the UIP. As of June 30, 2018, the UIP had total fiduciary net position of approximately \$18.6 billion in comparison to a beginning fiduciary net position of approximately \$17.7 billion, as restated. The beginning of the year restatement is included in the condensed Statement of Changes in Fiduciary Net Position. The following is a condensed Statement of Fiduciary Net Position of the UIP as of June 30, 2018 as compared to the prior year:

<b>Fiduciary Net Position Held in Trust for Pool and SMI participants (in thousands)</b>	<b><u>June 30, 2018</u></b>	<b><u>June 30, 2017</u></b>
<b>Assets</b>		
Total investments	\$ 18,601,994	\$ 17,681,763
Receivables and other assets	<u>201,494</u>	<u>217,368</u>
<b>Total assets</b>	<b>18,803,488</b>	<b>17,899,131</b>
<b>Liabilities</b>		
Payables	<u>202,591</u>	<u>264,724</u>
<b>Total liabilities</b>	<u>202,591</u>	<u>264,724</u>
<b>Fiduciary net position</b>	<b><u>\$ 18,600,897</u></b>	<b><u>\$ 17,634,407</u></b>

As of June 30, 2018, most of the assets were composed of investments at either fair value or at net asset value (NAV) in accordance with GAAP. There is a large measure of unpredictability in these balances from year to year due to these variations.

The receivables and other assets include amounts for broker receivable for securities sold but not settled, accrued interest and dividends and collateral held for securities lending transactions. The payables are similar, but also include income due to participants.

*SMI Montana Mortgages and Loans, Tax Abatement, Bond and Loan Guarantees.* The SMI portfolio continues to include mortgages and loans funded by the Coal Severance Tax Trust Fund as authorized by statute. The carrying value of the mortgages and loans was approximately \$181 million as compared to approximately \$161 million as of the end of the prior year. During the fiscal year, approximately \$285 thousand in mortgages and loans were written down and in foreclosure.

The SMI also includes a tax abatement program by statute. The eligible abatements are administered by local governments but approved by the Board. Various eligibility requirements are in statute to afford the business an interest rate reduction on an infrastructure loan. For the fiscal year ended June 30, 2018, the amount claimed as credits against various forms of state taxation was approximately \$1.4 million, as compared to approximately \$3.4 million in the prior fiscal year.

Finally, various bond and loan guarantees are provided from STIP, the Coal Severance Tax Trust, and the State Treasurer's Cash Fund to the Enterprise Fund for exposure to INTERCAP bond issues and the Montana Facility Finance Authority. As of the end of the fiscal year, the Board has not had to perform on the guarantees. The amounts are merely commitments of the Board. STIP is an external investment pool managed by the Board. Both the Coal Severance Tax Trust Fund and the Enterprise Fund are part of the primary government for the State. The Board manages the State Treasurer's Cash Fund which consists of fund balances of all the funds of the State whose investment earnings are permitted by law to flow to the State's General Fund. As of the fiscal year ended June 30, 2018, the balance of guarantee activity was approximately \$187 million as compared to approximately \$179 million at the end of the prior fiscal year.

*Changes in Fiduciary Net Position - Beginning Balance Adjustment.* During the fiscal year, the Board reconsidered the presentation of a reserve account for the STIP which may be utilized to offset losses within the STIP portfolio. This account was reclassified from a liability to a component of fiduciary net position as of the beginning of the year and as portrayed in the following combined, condensed Statement of Changes in Fiduciary Net Position for the fiscal years ended June 30, 2018 and the prior fiscal year.

Changes in Fiduciary Net Position Held in Trust for Pool and SMI participants (in thousands)	For Fiscal Years Ending	
	June 30, 2018	June 30, 2017
<b>Additions</b>		
Purchases by participants	\$ 7,884,031	\$ 7,170,844
Investment earnings	1,118,249	1,321,800
Administrative and other investment expenses	(74,313)	(59,842)
Net investment income	1,043,936	1,261,958
Securities lending income, net of expense	1,753	2,774
<b>Total additions</b>	<b>8,929,720</b>	<b>8,435,576</b>
<b>Deductions</b>		
Sales by participants and distributions of income	7,987,465	7,539,659
<b>Change in fiduciary net position</b>	<b>942,255</b>	<b>895,917</b>
<b>Fiduciary net position, beginning of year (unadjusted)</b>	<b>17,634,407</b>	<b>16,738,490</b>
<b>Restatement</b>	<b>24,235</b>	<b>-</b>
<b>Fiduciary net position, end of year</b>	<b>\$ 18,600,897</b>	<b>\$ 17,634,407</b>

*Purchases and Distributions.* Purchases from and distributions to participants, including income will vary annually based upon activity of the participants and their cash flow needs.

*Administrative and Other Investment Expenses.* Administrative and other investment expenses include the flows to manage the UIP, custodial bank fees, external manager fees and other investment related expenses. The flows to manage the operations of the UIP, including general and administrative costs, are set by the State Legislature biennially and approved by the Board as part of an annual budget. Custodial banking fees are paid through a statutory appropriation and external manager fees are paid directly from the accounts they manage. These flows comprise the 'overhead' of the UIP. For the fiscal year ending June 30, 2018, these flows represented 0.31% of ending fiduciary net position (or 31 basis points) versus 0.29% of fiduciary net position (or 29 basis points) at the end of the prior year. The primary component relates to external manager fees, which the Board continues to aggressively monitor.

The net of all the flows, including the restatement, resulted in a \$967 million increase to fiduciary net position for the fiscal year ended June 30, 2018. This compares to an increase of approximately \$896 million in the prior year.

### **Economic Highlights**

The U.S. economic conditions during the past fiscal year can be summarized as solid growth in economic activity, continued improvements in the labor market, with increasing, but still low inflation.

Inflation rose gradually over the fiscal year but remains subdued compared to the long-term average. Recent inflation measures have been slightly above the Federal Reserve's medium-term target of 2%. Oil prices are a significant contributor to inflation estimates and expectations and increased meaningfully (approximately 60%) throughout the year.

Longer-term U.S. interest rates increased during the last year with the ten-year rate increasing by 0.56% to a nominal yield of 2.86% by June 30, 2018.

The U.S. Dollar experienced significant volatility (plus and minus 7%) relative to other major currencies during the fiscal year. The U.S. dollar declined relative to other currencies in the first-half of the year but gained back most of its losses in the last few months, resulting in a small depreciation relative to other currencies over the entire year.

### **Economic Factors and Currently Known Facts that May Impact UIP's Operations in the Future**

In the future, UIP's financial status will be influenced by cash flows in and out of the underlying components as well as the change in investment income and valuations across the different areas of investments. The performance of investments will be influenced by the economic, political, social, environmental, and behavioral changes of economies, countries, and capital market participants.

The consensus view of the market is that U.S. and global growth will remain low. Over shorter time periods, investment performance is expected to remain volatile. The Board will continue to manage the assets with belief that consistent execution of the investment process will have a significant influence on achieving the long-term objectives.

*GASB Statement No. 84, Fiduciary Activities.* Management of the Board is in the process of analyzing the changes that potentially may occur to the financial statements related to the issuance of GASB Statement No. 84, *Fiduciary Activities*, which will be implemented by the Board for the fiscal year ending June 30, 2020. The pools and SMI within the UIP will continue to be reported. Slight changes may occur relating to the recognition of liabilities, based on a compelling event to disburse resources.

*Requests for Information and Transparency.* This financial report is designed to provide a general overview of the UIP's operations. Questions concerning any of the information contained in this report or requests for additional information about the Board's operations, should be addressed to the Board at 2401 Colonial Drive, 3<sup>rd</sup> Floor, PO Box 200126,



Helena, Montana 59620-0126. The Board may be reached by phone at 406.444.0001, fax at 406.449.6579 or TDD at 406.841.2702. Board Meeting agenda and minutes are posted at <http://investmentmt.com/meetings>.

STATEMENT OF FIDUCIARY NET POSITION  
FOR FISCAL YEAR ENDING JUNE 30, 2018  
(in thousands)

Assets

Investments:

Cash and cash equivalents held at custodial bank	\$ 2,585,318
Investments at cost	180,618
Investments at fair value	<u>15,836,058</u>
Total investments	<u>18,601,994</u>

Securities lending cash collateral	<u>120,583</u>
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Receivables:

Broker receivable for securities sold but not settled	28,321
Dividend and interest receivable	<u>52,590</u>
Total receivables	<u>80,911</u>

Total assets	<u>18,803,488</u>
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Liabilities

Payables

Broker payable for securities purchased but not settled	50,955
Income due participants	20,774
Other payables	5,526
Administrative fee payable	4,753

Securities lending obligations	<u>120,583</u>
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Total liabilities	<u>202,591</u>
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Net position held in trust for pool and Separately Managed Investments (SMI) participants	<u>\$ 18,600,897</u>
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The accompanying notes are an integral part of these financial statements.

STATEMENT OF CHANGES IN FIDUCIARY NET POSITION  
FOR FISCAL YEAR ENDING JUNE 30, 2018  
(in thousands)

Additions

Purchases by participants	\$ 7,884,031
Net investment earnings	
Investment earnings:	
Net increase (decrease) on fair value of investments	769,871
Dividend/interest income	344,589
Other investment income	3,789
Investment earnings	<u>1,118,249</u>
Administrative expenses	(57,117)
Other investment expenses	<u>(17,196)</u>
Net investment income	<u>1,043,936</u>
Securities lending income	3,066
Securities lending expense	<u>(1,313)</u>
Net securities lending income	<u>1,753</u>
Total additions	<u>8,929,720</u>

Deductions

Sales by participants	7,796,023
Income distributions to participants	<u>191,442</u>
Total deductions	<u>7,987,465</u>
Change in net position	<u>942,255</u>
Net position held in trust for pool and SMI participants - beginning of year	17,634,407
Adjustment to beginning net position (Note 2)	<u>24,235</u>
Beginning of the year net position - as adjusted	<u>17,658,642</u>
Net position held in trust for pool and SMI participants - end of year	<u><u>\$ 18,600,897</u></u>

The accompanying notes are an integral part of these financial statements.

## **NOTES TO FINANCIAL STATEMENTS FOR THE FISCAL YEAR ENDED JUNE 30, 2018**

These financial statements present only the activity of the Unified Investment Program (UIP) as managed by the Board of Investments (the Board). The financial information pertaining to the UIP administrative operations of the Board can be found in the Investment Division internal service fund contained within the State of Montana's (the State) Comprehensive Annual Financial Report (CAFR). The State's CAFR is available from the Montana Department of Administration's State Financial Services Division website <http://sfsd.mt.gov/SAB/cafr>; at Room 255 Mitchell Building, 125 North Roberts Street, PO Box 200102, Helena, MT 59620-0102 or at 406-444-3092.

### **1. DESCRIPTION OF FUNDS AND SIGNIFICANT ACCOUNTING POLICIES**

#### **Description of Funds**

The UIP is by statute comprised of involuntarily participating state funds, including pensions, trusts, insurance, operating funds and by statute voluntarily participating local government funds. To facilitate management of the UIP, the Board uses a combination of investment pools and Separately Managed Investments (SMI) to meet the financial goals and expectations of the agencies and entities which entrust these funds to the Board. The reports within these financial statements become part of the governmental, proprietary and fiduciary fund categories of the State's CAFR.

#### **Basis of Accounting**

The accompanying financial statements are reported using the economic resources measurement focus and the accrual basis of accounting and have been prepared in conformity with accounting principles generally accepted in the United States for governments (GAAP) as established by the Governmental Accounting Standards Board (GASB).

#### **Cash and Cash Equivalents held within Pools**

Cash and cash equivalents generally, are short-term, highly liquid investments with maturities of three months or less at time of purchase. The Consolidated Asset Pension Pool (CAPP), the Trust Funds Investment Pool (TFIP) and the Short-Term Investment Pool (STIP) hold cash and cash equivalents that are measured at cost.

#### **Valuation of Investments**

Investments are reported at fair value on a trade date basis. Quoted market prices, when available, have been used to value investments. The fair values for securities that have no quoted market price represent estimated fair value. Alternative investment securities are valued using the most recent estimates of fair value from the investment managers. Fair value measurements are reviewed monthly, and third-party valuations are reviewed for reasonableness and compliance with approved price source authorization policy. Additional information on how the Board reports fair value measurements can be found in Note 7 - Fair Value Measurement.

#### **Revenue Recognition**

Unrealized gains and losses are included as a component of investment income in the Statement of

Changes in Fiduciary Net Position. Unrealized gains and losses are computed based on changes in the fair value of investments held from the beginning of the year, but unsold at the fiscal year end. The net change in fair value of investments also consists of the realized gains or losses. Interest income is recognized when earned. Dividend income is recorded on the ex-dividend date.

### Investment Fees

The State Legislature sets management fees the Board charges. The maximum fee is set at the aggregate level at the beginning of each fiscal year. The Board allocates the aggregate fees across the Pools, and SMI outside the Pools. Custodial bank fees are paid by a statutory appropriation from the State's general fund. The Board allocates custodial bank fees across the Pools and SMI and deposits the funds required to pay the fee in the general fund. The State Treasurer then pays the monthly custodial bank fees from the general fund. External manager fees are paid directly from the accounts they manage.

Investment fees charged to each Pool and the SMI investments are shown in the following table:

Total Fiscal Year 2018 Investment Fees (in thousands)					
<u>Pool and SMI</u>	<u>Board</u>	<u>Custodial Bank</u>	<u>External Managers</u>	<u>Total</u>	<u>Investment Fee Ratio</u>
Consolidated Asset Pension Pool (CAPP)	\$ 3,730	\$ 1,249	\$ 47,834	\$ 52,813	0.47%
Trust Funds Investment Pool (TFIP)	331	126	1,648	2,105	0.09%
Short Term Investment Pool (STIP)	443	261	-	704	0.02%
Separately Managed Investments (SMI)	<u>677</u>	<u>127</u>	<u>691</u>	<u>1,495</u>	<u>0.09%</u>
Total	<u>\$ 5,181</u>	<u>\$ 1,763</u>	<u>\$ 50,173</u>	<u>\$ 57,117</u>	<u>0.31%</u>

### Securities Lending

The collateral received under securities lending agreements where the pools can spend, pledge, or sell collateral without borrower default is included in the Statement of Fiduciary Net Position. Liabilities resulting from these transactions are also included in the Statement of Fiduciary Net Position. Costs associated with the securities lending transactions, including broker commissions and lending fees paid to custodians are reported as components of investment expenses in the Statement of Changes in Fiduciary Net Position. Securities lending income reported for the fiscal year was \$3.1 million, and expenses associated with securities lending were \$1.3 million. For further detail see Note 5 - Securities Lending.

### Purchases and Sales by Participants

Purchases and sales by participants are recorded when received or paid. TFIP and STIP participants receive monthly income distributions. SMI distributes when income is received. TFIP, STIP, and SMI distributable income includes net investment earnings, excluding the net increase (decrease) on the fair value of investments. TFIP and SMI distributable income also includes net securities lending earnings. TFIP and STIP distributable income also includes amortization and accretion of securities purchased at a discount or premium. CAPP retains all its investment earnings; therefore, it does not distribute to participants.

### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Actual results could differ from estimated amounts.

### Regulatory Oversight

The Board was created by the State Legislature to manage the UIP established by the State Constitution. The Board is not registered with the U.S. Securities and Exchange Commission as an investment company.

### Pool Participant Units

Pool units are purchased and sold in the same manner as individuals investing in mutual funds. Therefore, the pool unit price is computed based on market prices on securities in the pool plus any additional assets, minus liabilities. The STIP participants purchase and sell units, at \$1 per unit, at the participant's discretion. CAPP and TFIP units and SMI direct investments are purchased and sold at the discretion of board investment staff based on asset allocations and Investment Policy Statements (IPS) approved by the Board. Individual investments in the pools are not specifically identified to the respective participants. Gains and losses on the sale of CAPP and TFIP participant units are reflected at the participant level. SMI is not a pool; therefore, there are neither units outstanding nor unit values calculated.

## 2. OTHER ACCOUNTING CHANGES

### Adjustment to Beginning Net Position

In November 2007, the STIP Reserve account was established. The STIP Reserve account may be used to offset losses within the STIP portfolio. STIP distributes income to its participants based on accrued interest and discount amortization, net of fees and STIP Reserve expense. Prior to the fiscal year ending June 30, 2018, the STIP Reserve was reported as a liability, instead of as a component of fiduciary net position in accordance with GAAP. As shown in the Statement of Changes in Fiduciary Net Position, the Board restated the liability as an increase to fiduciary net position of \$24.2 million as of July 1, 2017. For further detail see Note 13 - STIP Reserve.

### Separately Managed Investments (SMI)

As of June 30<sup>th</sup>, the Board separately managed investments outside of the pools on behalf of 16 participants. The investments are combined for reporting purposes in the SMI portion of the UIP. In previous financial statements, the SMI portion of the UIP was referred to as All Other Funds (AOF). SMI participants include the State Treasurer's fund, state agency insurance reserves, and other state agencies. SMI participation is at the discretion of the Board staff for state agencies allowed to participate in the UIP.

### Cash and Cash Equivalents – Change in Valuation Method

During the fiscal year ended June 30, 2018, the Board reevaluated the measurement of cash and cash equivalents and aligned reporting of such investments at cost. Under GASB, cash equivalents can be reported under either the fair value or cost basis. The Board analyzed the immaterial difference in cash equivalents between their fair value and cost and determined the more relevant disclosure was under the cost method. Such a change did not cause a restatement of beginning net position due to the immaterial impact on beginning net position.

### 3. INVESTMENT COMMITMENTS

Investments in alternative equity are usually made via limited partnership agreements that involve many limited partners and a general partner who is responsible for all investment decisions. The limited partners make an original commitment, after which capital is called as needed by the general partner to make investments. These agreements will usually last for a minimum of 10 years. The following table shows the remaining Board commitments to CAPP alternative equity managers by pension asset class (PAC).

Commitments to Fund Managers as of June 30, 2018 (in thousands)		
<u>Pension Asset Class</u>	<u>Original Commitment</u>	<u>Commitment Remaining</u>
Private Equities PAC	\$ 2,580,722	\$ 807,355
Real Estate PAC	1,655,262	365,064
Natural Resources PAC	420,000	149,181
Total	<u>\$ 4,655,984</u>	<u>\$ 1,321,600</u>

### 4. INVESTMENT RISK DISCLOSURES

#### Custodial Credit Risk (Cash and Cash Equivalents and Investments Held at Custodial bank)

Custodial credit risk is the risk that, in the event of the failure of the counterparty to a transaction, the Board will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. Per policy, the Board's custodial bank must hold short-term and long-term credit rating by at least one Nationally Recognized Statistical Rating Organization (NRSRO) with a minimum requirement of A1/P1 (short-term) and A3/A-1 (long-term).

As of June 30<sup>th</sup>, all the public securities as well as securities held by the separate public equity account managers were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank. The equity index funds, securities held at the State's depository bank, real estate, mortgage and loan investments were purchased and recorded in the Board's name. Commingled fund investments are registered in the name of the Montana Board of Investments.

### Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of any single investment per issuer name. Investments explicitly guaranteed by the U.S. Government are excluded from the concentration of credit risk requirement. Concentration of credit risk is addressed within all IPSs as set by the Board. Please refer to Note 6 – Summary of Investment Policy – Legal and Contractual Provisions footnote for further detail.

### Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. Except for U.S. Government securities, the pools' fixed income instruments have credit risk as measured by NRSRO ratings. Credit risk is contemplated for each individual portfolio in the IPS. Credit risk is managed by constraining portfolio purchases around investment grade NRSRO ratings as appropriate. The U.S. Government guarantees its securities directly or indirectly. Obligations of the U.S. Government or obligations explicitly guaranteed by the U.S. Government are not considered to have credit risk and do not require disclosure of credit risk. Please refer to Note 6 – Summary of Investment Policy – Legal and Contractual Provisions footnote for further detail.

The CAPP's cash equivalents position held at its custodial bank was unrated with approximately \$330.3 million held in Money Market Funds and an additional \$4.3 million was held by the CAPP's fiscal agent as of the end of the fiscal year. The Board determined that there was no significant credit quality risk associated with the cash equivalents as of June 30th and has not suffered a loss event as of the audit opinion date on the cash equivalents as of June 30<sup>th</sup>.

As a matter of STIP investment policy, board fixed income investment staff can only purchase securities from a pre-approved "Approved Issuer" list. By STIP policy, permitted money market investments include only SEC registered 2a-7 Institutional Money Market Funds that are considered "US Treasury" or "US Government" money market mutual funds according to the SEC regulations or short-term investment vehicle available through the custodial bank. As of June 30<sup>th</sup>, all the STIP money market investments were in US Governmental Money Markets. The Board determined that there was no significant credit quality risk associated with the cash equivalents as of June 30th and has not suffered a loss event as of the audit opinion date on the cash equivalents as of June 30<sup>th</sup>. For the STIP, the Cash Equivalent Credit Quality Ratings as of June 30<sup>th</sup> were as follows:



STIP Cash Equivalent Credit Quality Ratings as of June 30, 2018 (in thousands)		
<u>Cash Equivalent Investment Type</u>	<u>Total Fixed Income Investments at Fair Value</u>	<u>Credit Quality Rating</u>
Treasuries	\$ 239,483	A-1+
Asset Backed Commercial Paper	1,105,685	A-1
Corporate:		
Commercial Paper	233,356	A-1+
Notes	55,004	A-1+
Certificates of Deposit	124,915	A-1
U.S. Government Agency	351,707	A-1+
U.S. Government Money Market Funds	140,357	A-1+
Cash Held at Fiscal Agent	162	NR
Total Cash Equivalent	<u>\$ 2,250,669</u>	

### Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Board uses effective duration as a measure of interest rate risk for all fixed income portfolios. Please refer to Note 6 – Summary of Investment Policy – Legal and Contractual Provisions footnote for further detail.

CAPP, TFIP, and SMI investments at fair value are categorized to disclose credit and interest rate risk on the following table for fixed income securities. Credit risk is disclosed using the weighted credit quality rating by investment type. Interest rate risk is disclosed using weighted effective duration. The credit quality ratings have been calculated excluding non-rated investment types. NRSRO provides the credit ratings presented in the following tables.

Credit Quality Rating and Effective Duration as of June 30, 2018 Fair Values (in thousands)						
<u>Security Investment Types</u>	<u>CAPP</u>	<u>TFIP</u>	<u>SMI</u>	<u>Total Fixed Income Investments at Fair Value</u>	<u>Credit Quality Ratings Range</u>	<u>Effective Durations (Years)</u>
Treasuries	\$ 1,226,714	\$ 536,787	\$ 330,905	\$ 2,094,406	AAA	3.61-7.59
Agency or Government Related	130,363	137,558	264,686	532,607	AAA	3.06-6.06
Asset Backed Securities	14,743	81,854	44,314	140,911	AAA	2.07-2.74
Mortgage Backed Securities:						
Noncommercial	480,163	446,905	38,563	965,631	AAA	5.11-5.82
Commercial	56,498	144,288	16,406	217,192	AAA	4.36-6.12
Corporate:						
Financial	261,035	275,280	250,987	787,302	BBB+, A-	3.15-4.46
Industrial	431,025	416,570	316,685	1,164,280	BB+, A	4.09-6.66
Utility	24,967	23,463	21,413	69,843	BBB, BBB+	2.75-4.69
High Yield Bond Fund	-	100,994	-	100,994	B	3.64
Total Fixed Income Investments at Fair Value	<u>\$ 2,625,508</u>	<u>\$ 2,163,699</u>	<u>\$ 1,283,959</u>	<u>\$ 6,073,166</u>		

STIP investments at fair value are categorized to disclose credit risk and weighted average maturity (WAM). Credit risk reflects the weighted security quality rating by investment type as of the June 30th report date. Although the STIP investments have been rated by investment security type, STIP, as an external investment pool, has not been rated. STIP interest rate risk is determined using the WAM method. The WAM measure expresses investment time horizons – the time when investments are due or reset and payable in days, months or years – weighted to reflect the dollar size of the individual investments within an investment type. Inclusive of cash and cash equivalents, the WAM averages 46 days for the portfolio.

STIP Credit Quality Ratings and Weighted Average Maturity as of June 30, 2018 (in thousands)			
<u>Security Investment Type</u>	<u>Total Fixed Income Investments at Fair Value</u>	<u>Credit Quality Rating</u>	<u>WAM (Days)</u>
Treasuries	\$ 19,900	A-1+	97
Corporate:			
Commercial Paper	288,944	A-1	71
Notes	225,121	A-1+	67
Certificates of Deposit	546,591	A-1	42
Total STIP Fixed Income Investments at Fair Value	<u>\$ 1,080,556</u>		

Based on their short weighted average maturity and the relative immaterial difference from their cost to fair value as of June 30<sup>th</sup>, the Board deemed the cash equivalents to have little discernible interest rate

risk. In addition, the Board has not suffered a loss event as of the audit opinion date on the cash equivalents as of June 30<sup>th</sup>.

#### Foreign Currency Risk

Foreign currency risk is the risk that changes in the exchange rates will adversely affect the fair value of an investment.

The Board's foreign currency exposure by denomination and investment type are reported, in U.S. dollars, at fair value. The following table excludes the foreign investments denominated in U.S. dollars for the American Depositary Receipts (ADRs), sovereign debt and commingled index funds.

Foreign Currency Exposure by Country Investment Type in U.S. Dollar Equivalent (in thousands) As of June 30, 2018				
Foreign Currency Denomination	Currency	Equities	Private Equity	Real Estate
Australian Dollar	\$ -	\$ 23,306	\$ -	\$ -
Brazilian Real	-	14,814	-	-
Canadian Dollar	65	53,456	-	-
Danish Krone	-	13,104	-	-
EMU-Euro	46	168,668	21,400	2,000
Hong Kong Dollar	1	37,984	-	-
Indonesian Rupiah	25	623	-	-
Japanese Yen	322	109,401	-	-
Malaysian Ringgit	16	2,626	-	-
Mexican Peso	2	2,430	-	-
New Israeli Sheqel	-	3,686	-	-
Korean Fortnit	4	15,946	-	-
New Zealand Dollar	-	238	-	-
Norwegian Krone	-	11,022	-	-
Philippine Peso	1	1,201	-	-
Polish Zloty	3	2,161	-	-
Pound Sterling	248	103,975	-	-
Singapore Dollar	77	12,089	-	-
South Africian Rand	-	14,129	-	-
South Korean Won	-	25,224	-	-
Swedish Krona	-	22,659	-	-
Swiss Franc	-	32,240	-	-
New Taiwan Dollar	-	4,887	-	-
Thailand Baht	6	5,141	-	-
Yuan Renminbi	94	7,774	-	-
Philippine Piso	-	34	-	-
Total	<u>\$ 910</u>	<u>\$ 688,818</u>	<u>\$ 21,400</u>	<u>\$ 2,000</u>

## 5. SECURITIES LENDING

The Board is authorized by law to lend its securities and has contracted with the custodial bank, to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The custodial bank is required to maintain collateral equal to 102 percent of the fair value of domestic securities and 105 percent of the fair value of international

securities while the securities are on loan. On any day, including June 30th, the markets may move in a positive or negative direction resulting in under or over collateralization. The custodial bank compensates for market movement by recalculating on the following business day to meet the collateralization requirements. The Board and the custodial bank split the earnings 80% and 20% respectively, on securities lending activities. The Board retains all rights and risks of ownership during the loan period. The custodial bank indemnifies the Board's credit risk exposure to the borrowers.

During the fiscal year, the custodial bank loaned the Board's public securities and received as collateral: U.S. dollar cash; U.S. Government and government sponsored agency securities; U.S. corporate debt securities and structured securities rated AA- or Aa3 or higher; sovereign debt securities of the Group of Ten nations; and debt securities issued by certain supranational agencies. The custodial bank does not have the ability to sell collateral securities unless the borrower defaults.

The Board imposed no restrictions on the amount of securities available to lend during the fiscal year. However, STIP assets are currently not available for securities lending. There were no failures by any borrowers to return loaned securities or pay distributions thereon during the period that resulted in a declaration and notice of default of the borrower. There were no losses during the fiscal year resulting from a borrower default. As of June 30<sup>th</sup>, no securities were recalled and not yet returned.

The cash collateral received for each loan was invested, together with the cash collateral of other qualified plan lenders, in an investment fund, the Navigator Securities Lending Government Money Market (Navigator) portfolio.

The Board and the borrowers maintain the right to terminate all securities lending transactions on notice. Because the securities lending transactions were terminable at will, their duration did not generally match the duration of the investments made with the cash collateral received from the borrower. The average duration was 10 days and the average weighted final maturity was 70 days within the Navigator portfolio.

<u>Pool and SMI</u>	Securities on Loan and Pledged Collateral (in thousands)				
	As of June 30, 2018				
	<u>Fair Value On Loan</u>	<u>Collateral Cash</u>	<u>Collateral Securities</u>	<u>Collateral Total</u>	<u>% of Fair Value</u>
Consolidated Asset Pension Pool (CAPP)					
Domestic	\$ 646,690	\$ 62,947	\$ 596,205	\$ 659,152	102%
International	43,563	10,661	35,003	45,664	105%
Trust Funds Investment Pool (TFIP)	247,461	32,583	220,050	252,633	102%
Separately Managed Investments (SMI)	<u>131,353</u>	<u>14,392</u>	<u>119,661</u>	<u>134,053</u>	<u>102%</u>
Total	<u>\$ 1,069,067</u>	<u>\$ 120,583</u>	<u>\$ 970,919</u>	<u>\$ 1,091,502</u>	

Fiscal Year 2018 Securities Lending Income and Expenses (in thousands)			
<u>Pool and SMI</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>Net Income</u>
Consolidated Asset Pension Pool (CAPP)	\$ 2,172	\$ (838)	\$ 1,334
Trust Funds Investment Pool (TFIP)	502	(241)	261
Separately Managed Investments (SMI)	392	(234)	158
Total	<u>\$ 3,066</u>	<u>\$ (1,313)</u>	<u>\$ 1,753</u>

## 6. SUMMARY OF INVESTMENT POLICY – LEGAL AND CONTRACTUAL PROVISIONS

The Board manages the Investment Program pursuant to the “Prudent Expert Principle” mandated by state law, which requires an investment manager to:

- (a) discharge the duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;
- (b) diversify the holdings of each fund within the UIP to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so; and
- (c) discharge the duties solely in the interest of and for the benefit of the funds forming the UIP.

### Allowed Investments

All investment policy statements are approved by the Board.

State agencies and local government entities may participate in one or more Pools. By investing in Pools, participants are provided broad diversification. State agencies may also have direct fixed income, equity or loan investments. These investments are combined and reported as SMI. Currently, only the nine retirement funds through participation in CAPP, Defined Contribution Disability Plan, and the Montana State Fund (Workers’ Compensation) may invest in public corporate capital stock. Neither State law nor the State Constitution place restrictions on retirement fund investments. The Board approves a separate IPS for each pool and SMI participant, which provides board staff a broad strategic framework under which the investments are managed. The IPSs also reflects the Board approved asset allocation ranges.

By statute, local government entities can voluntarily invest in the STIP. By statute, with a qualifying event, local government entities may also voluntarily invest in the TFIP.

### CAPP

The CAPP IPS contains prescribed asset allocation ranges among the allowable asset classes and is subject to change as modifications are adopted by the Board. The Board annually affirms or revises the asset allocation ranges for the retirement plans. The CAPP IPS also contains investment objectives and guidelines for each underlying asset class, with a purpose of providing diversified exposure within the asset class in a prudent and cost-effective manner.

Due to a longer-term focus, CAPP's asset classes differ from other classes that are allowable for other programs. CAPP's underlying asset classes are as follows:

- |   |                              |
|---|------------------------------|
| • Domestic Equities                                   | • Broad Fixed Income         |
| • International Equities                              | • U.S. Treasury/Agency       |
| • Private Equities                                    | • Investment Grade           |
| • Natural Resources                                   | • Mortgage Backed Securities |
| • Real Estate   | • High Yield                 |
| • U.S. Treasury Inflation-Protected Securities (TIPS) | • Cash                       |
|   | • Diversifying Strategies    |

The CAPP IPS is the only IPS that allows for investments that can be held in non-U.S. securities in a foreign currency. Per the CAPP IPS, the Investment Grade Credit Asset Class, Agency Mortgage Backed Securities Asset Class, and High Yield Asset Class sections have maximum restrictions that can be held. Currency exposures may be hedged, in a defensive manner, at the discretion of the active managers to preserve the U.S. dollar value of investments made.

#### TFIP

The TFIP IPS provides for a 2% portfolio limit for dollar denominated debt obligations of domestic and foreign corporations (also known as 'Yankee bonds') and a 3% portfolio limit in non-agency mortgage pass-through (MBS) securities. TFIP invests primarily in investment grade, U.S. dollar denominated fixed income securities. The portfolio has high yield and core real estate exposure.

#### STIP

The STIP IPS limits concentration of credit risk exposure by limiting portfolio investment types to 3% in any issuer except for U.S. Treasury and US Agency securities as well as any repurchase agreements with a financial institution.

STIP invests primarily in short-term, high quality, fixed income securities with a maximum maturity of 397 days or less. Variable securities shall have a maximum maturity of 2 years. STIP shall maintain a dollar-weighted average portfolio maturity of 60 days or less. STIP is managed to preserve principal while providing 24-hour liquidity for state agency and local government participants.

Per the STIP IPS, "The STIP portfolio will minimize interest rate risk by:

- 1) structuring the investment portfolio so securities mature to meet cash requirements for ongoing operations thereby normally avoiding the need to sell securities on the open market prior to maturity;
- 2) maintaining a WAM of 60 days or less (for this purpose, the date to the next coupon reset date will be used for all floating or variable rate securities); and
- 3) STIP will maintain a reserve account."

## SMI

SMI invests primarily in investment grade, U.S. dollar denominated fixed income securities. However, one participant portfolio has exposure to core real estate. The SMI portfolio also includes Veteran's Home Loan mortgages (VHLM) and commercial loans.

The SMI Montana loans receivable represent commercial loans funded from the Coal Severance Tax Trust Fund by the Board and Montana Facility Finance Authority. The VHLM are also funded from the Coal Severance Tax Trust Fund. The Coal Severance Tax Trust Fund loan portfolio also includes loans made by the abolished Montana Science and Technology Alliance (MSTA) Board. Please refer to Note 10 – SMI Montana Mortgages and Loans footnote for further detail.

## Other Policy Considerations

For other risk, the Board approves both the IPS and benchmark used for each portfolio. Per the CAPP IPS, the TIPS PAC, U.S. Treasury/Agency PAC, Investment Grade Credit PAC, and Agency Mortgage-Backed PAC, average duration will be maintained in a range within 20% of the benchmark duration. The Broad Fixed Income PAC and High Yield PAC average duration will be maintained in a range within 25% of the index duration. Per the TFIP IPS, the average duration will be maintained in a range within 20% of the benchmark duration. Interest rate risk for SMI is contemplated in each individual IPS and is managed by limiting the maturity of individual securities and/or matching liabilities to maturities per estimated cash flows.

CAPP, TFIP, SMI, and STIP may hold fixed and variable rate securities. Interest payments on variable securities are based on an underlying reference rate, for example, the London Interbank Offered Rate (LIBOR).

## 7. FAIR VALUE MEASUREMENT

The Board categorizes its fair value measurements within the fair value hierarchy established by GAAP as follows:

Level 1 - Quoted prices for identical assets or liabilities in active markets.

Level 2 - Prices determined using inputs, other than quoted prices included within Level 1, that are observable for an asset or liability, either directly or indirectly.

Level 3 - Prices are determined using unobservable inputs.

Valuations not classified within these levels are further explained in the Investments at Net Asset Value section of the footnote.

## Fair Value Level

CAPP, STIP and SMI - Fixed income and equity investments classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities. Fixed income investments classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices.



CAPP – Residential Mortgages classified in Level 3 of the fair value hierarchy are present value adjusted. Direct real estate classified in Level 3 of the fair value hierarchy are based on the latest appraised value.

Pools and SMI – Investments measured at cost are included to account for all investments within each pool and SMI. These assets represent cash equivalents and Montana Mortgages and Loans.

For each of the pools and SMI the Board has the following fair value measurements as of June 30th:

Investments Measured at Fair Value (in thousands)		Fair Value Measurements Using		
	June 30, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable (Level 3)
<u>Investments by fair value level</u>				
Fixed income investments:				
Treasuries	\$ 2,114,306	\$ 2,114,306	\$ -	\$ -
Agency or Government Related	532,607	-	532,607	-
Asset Backed Securities	140,911	-	140,911	-
Mortgage Backed Securities	965,631	-	965,631	-
Commercial Mortgage Backed Securities	217,192	-	217,192	-
Corporate:				
Commercial Paper	288,944	-	288,944	-
Commercial Notes	225,121	-	225,121	-
Certificates of Deposit	546,591	-	546,591	-
Financial	787,302	-	787,302	-
Industrial	1,164,280	-	1,164,280	-
Utility	69,843	-	69,843	-
Equity investments:				
Consumer Discretionary	269,082	269,082	-	-
Consumer Staples	71,850	71,850	-	-
Energy	108,933	108,933	-	-
Financials	267,097	267,097	-	-
Health Care	228,681	228,681	-	-
Industrials	274,462	274,462	-	-
Information Technology	444,999	444,999	-	-
Materials	90,942	90,942	-	-
Mutual Funds	2,233,394	2,233,394	-	-
Real Estate	41,022	41,022	-	-
Telecommunication Services	12,920	12,920	-	-
Utilities	30,738	30,738	-	-
International Equity investments:				
Consumer Discretionary	111,748	111,748	-	-
Consumer Staples	84,360	84,360	-	-
Energy	50,331	50,331	-	-
Financials	154,819	154,819	-	-
Health Care	54,635	54,635	-	-
Industrials	116,210	116,210	-	-
Information Technology	128,410	128,410	-	-
Materials	37,300	37,300	-	-
Mutual Funds	270,338	270,338	-	-
Private Placement	1,239	1,239	-	-
Real Estate	13,427	13,427	-	-
Rights/Warrants	15	15	-	-
Telecommunication Services	12,031	12,031	-	-
Utilities	4,876	4,876	-	-
Direct Real Estate	19,185	-	-	19,185
Residential Mortgages	3,861	-	-	3,861
Total investments by fair value level	12,189,633	\$ 7,228,165	\$ 4,938,422	\$ 23,046
<u>Investments measured at the net asset value (NAV)</u>				
Commingled Equity Index Funds	1,116,165			
Private Equity - Private Equity Partnerships	1,365,239			
Core Real Estate	557,350			
Non-Core Real Estate	396,524			
Timber	110,153			
High Yield Bond Fund	100,994			
Total investments measured at NAV	3,646,425			
Total investments measured at fair value	15,836,058			
<u>Investments at Cost</u>				
Cash and cash equivalents held at custodial bank	2,585,318			
Montana Mortgages and Loans	180,618			
Total investments not categorized	2,765,936			
Total investments	\$ 18,601,994			

## Investments at Net Asset Value (NAV)

The investments measured at NAV for the fiscal year are further detailed below:

Investments Measured at NAV (in thousands)	June 30, 2018			
	Fair Value	Unfunded Commitments	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
CAPP				
Commingled Equity Index Funds	\$ 936,139	\$ -	Daily	1 day
Private Equity - Private Equity Partnerships	1,365,239	938,879		
Core Real Estate	329,903	80,000	Monthly, quarterly	45-90 days
Non-Core Real Estate	396,524	285,064		
Timber	110,153	17,657		
Total investments measured at NAV	<u>\$ 3,137,958</u>	<u>\$ 1,321,600</u>		
TFIP				
Core Real Estate	\$ 138,538		Monthly, quarterly	45-90 days
High Yield Bond Fund	100,994		Monthly	30 days
Total investments measured at NAV	<u>\$ 239,532</u>			
SMI				
Core Real Estate	\$ 88,909		Monthly, quarterly	45-90 days
Commingled Equity Index Funds	180,026		Daily	1 day
Total investments measured at NAV	<u>\$ 268,935</u>			

Commingled Equity Index Funds - This type consists of institutional investment funds that invest in domestic equities and funds that invest in international equities. The fair values of the investments of this type have been determined using the NAV per share (or its equivalent) of the investments.

High Yield Bond Fund - This type consists of predominantly U.S. corporate credits, whether in the form of bonds or loans that are rated below investment grade. These assets carry a higher risk of default than investment grade securities and accordingly provide a higher level of income or yield commensurate with that risk. The fair values of the investments of this type have been determined using the NAV per share (or its equivalent) of the investments.

Core Real Estate - This type includes funds that invest primarily in core real estate, which makes equity investments in operating and substantially-leased institutional quality real estate in traditional property types (apartments, office, retail, industrial and hotel) via commingled funds. The primary investment objectives of these core real estate funds are to invest in real estate that will generate income from predictable sources of revenue and not to realize gains on the underlying assets. This investment type receives distributions of generated income and occasionally through the liquidation of the underlying assets of the fund. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of the Board's ownership interest in the partners' capital. Redemption of these investments is restricted based on the availability of cash flow arising from investment transactions, sales, and other fund operations occurring in the ordinary course of business. Therefore, requested redemptions from a fund will be redeemed as funds become available.

Non-Core Real Estate - This type includes private partnership funds that primarily invest in value added and opportunistic real estate funds. These funds assume more risk than the core real estate funds to

achieve a greater return on investment. Returns are driven both by current income and by expected capital appreciation. This investment type receives distributions of generated income and occasionally through the liquidation of the underlying assets of the fund. It is expected that the underlying assets of the funds will be liquidated over 7 to 10 years. These investments can never be redeemed with the funds. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of the Board's ownership interest in the partners' capital.

Timber - This type includes private partnership funds that primarily invest in timber funds. The underlying assets of these types of funds are typically made of tree farms and managed forest. Returns come from biological growth, upward product class movement, and appreciation in timber and land prices. This investment type receives distributions of generated income and occasionally through the liquidation of the underlying assets of the fund. It is expected that the underlying assets of the funds will be liquidated over 12 to 20 years. These investments can never be redeemed with the funds. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of the Board's ownership interest in the partners' capital.

Private Equity Partnerships - This type includes investments in limited partnerships. Generally speaking, the types of partnership strategies included in this portfolio: venture capital, growth equity, buyouts, special situations, mezzanine, and distressed debt. These investments are considered illiquid. Redemptions are restricted over the life of the partnership. During the life of the partnerships, distributions are received as underlying partnership investments are realized. It is expected that the underlying assets of the funds will be liquidated over 10 years. It is probable all the investments in this type will be sold at an amount different from the NAV per share (or its equivalent) of the Board's ownership interest in partners' capital.

## 8. FAIR VALUE OF DERIVATIVES INVESTMENTS

The UIP invests in currency forward contracts, index futures (long duration) and rights which are classified as investment derivatives. The derivatives increased in fair value for the fiscal year ended June 30, 2018 by \$170 thousand. The contracts had a fair value of \$15 thousand as of the end of the fiscal year. The notional amount of the contracts was \$818 thousand.

## 9. COAL SEVERANCE TAX TRUST FUND LOAN AND MORTGAGE COMMITMENTS

The Board makes firm commitments to fund commercial loans and residential mortgages from the Coal Severance Tax Trust Fund. These commitments have expiration dates and may be extended per Board policies. As of June 30<sup>th</sup>, the Board had committed, but not yet purchased, \$29.4 million in loans from Montana lenders. In addition to the above commitments, lenders had reserved \$5.9 million for loans as of June 30<sup>th</sup>. An additional, \$3.5 million represented lender reservations for the VHLM residential mortgage purchases with no purchase commitments.

The Board makes reservations to fund residential mortgages from the state's pension funds. As of June 30<sup>th</sup>, there were no residential mortgage reservations. All Board residential mortgage purchases are processed by the Montana Board of Housing (MBOH). The MBOH does not differentiate between a residential mortgage reservation and a funding commitment.

## 10. SMI MONTANA MORTGAGES AND LOANS

The SMI portfolio includes mortgages and loans, funded by the Coal Severance Tax Trust Fund as authorized by statute. The mortgages and loans are shown in the following table are reported at cost. The Montana Science and Technology Alliance (MSTA) loans include funding for research and development, mezzanine and seed capital loans.

Montana Mortgages and Loans as of June 30, 2018 (in thousands)	
Science and Technology Alliance	\$ 720
Montana University System	7,802
Montana Facility Finance	2,821
Local Government Infrastructure	19,890
Veterans' Home Loan Mortgages	36,413
Intermediary Relending Program (IRP) Loans	3,989
Commercial Loans	<u>108,983</u>
Total Montana Mortgages and Loans at cost	<u>\$ 180,618</u>

During the fiscal year, the Board wrote-down one commercial loan in an amount of \$285 thousand. The participating bank received a deed-in-lieu-of-foreclosure pertaining to this loan. The Board has an 80% participation in this loan. The property is currently on the market.

## 11. TAX ABATEMENT

Within the Board's SMI Commercial Loan Program, by statute the Infrastructure Loan Program is funded by an \$80 million allocation. Eligible local governments request a loan for constructing or purchasing infrastructure to be used by a basic sector business. The basic sector business will pay a user fee to the local government that is pledged to the Board for the loan repayment. The Board reviews each loan and only upon verification that the entities meet the loan requirements is the loan approved by the Board. The Board is part of the primary government of the State.

To be eligible for the program, the basic sector business must create at least 15 full-time basic sector jobs. The maximum loan size is a principal amount of \$16,666 multiplied by the number of full-time jobs created with a minimum loan size of \$250 thousand. The maximum loan term is 25 years. There is also up to a 2.5% interest rate reduction for job creation. The reduction will be reflected in the user fee rate charged to the basic sector business upon Board review and approval. The basic sector business must create the required jobs within four years of the agreement. If the basic sector business does not create the required jobs within the four-year period, then the basic sector business must pay down the loan balance of the local government entity until the loan balance matches the eligible amount per the jobs created. The Board may increase the interest rate commensurate with the number of jobs eliminated if the borrower eliminates 10 or more qualifying jobs. The basic sector business must annually provide payroll documentation to the Board.

Pursuant to statute, a business that is created or expanded as the result of an Infrastructure Loan is entitled to a credit against either their State individual income taxes or corporate income taxes for the portion of the fees attributable to the use of the infrastructure. The total amount of tax credit claimed may not exceed the amount of the loan. The credit may be carried forward for seven years or carried back for three years.

During the fiscal year, basic sector business entities made total user fee payments of \$3.5 million, representing \$2.4 million of principal and \$1.1 million in interest. During the fiscal year, a total of \$1.4 million was claimed as a credit against the State individual and corporation tax liability. The following table details the credit claimed by tax type and the tax year (TY) it was applied against.

Total Fiscal Year 2018 Infrastructure Credits Claimed				
	For TY 2017		For TY 2016	
	Corporate Income Tax	Individual Income Tax	Corporate Income Tax	Individual Income Tax
Amount Claimed (in thousands)	\$0	\$66	\$706	\$624
Number of Credits	0	16	*	*
* indicates less than 10. Number cannot be reported due to confidentiality concerns.				

The local government entity must pass a resolution authorizing the acceptance of the commitment agreement. The Board indemnifies the local government regarding repayment of the loan.

12. BOND AND LOAN GUARANTEES

As of June 30<sup>th</sup>, the Board had provided loan guarantees from STIP, the Coal Severance Tax Trust Fund, and the Treasurer’s Cash Fund to the Enterprise Fund for exposure to INTERCAP bond issues amounting to approximately \$105.1 million and to the Montana Facility Finance Authority (MFFA) amounting to approximately \$81.5 million as of June 30<sup>th</sup>. The Board has not had to perform on any bond and loan guarantee in the past.

STIP is an external investment pool managed by the Board. Both the Coal Severance Tax Trust Fund and the Enterprise Fund are part of the primary government for the State of Montana. The Board manages the Treasurer’s Cash Fund which consists of fund balances of all the funds for the State whose investment earnings are permitted by law to flow to the State’s general fund. The Board has irrevocably pledged to make loans to cure INTERCAP reserve account deficiencies and to purchase tendered bonds not redeemed or remarketed. The outstanding bonds have final maturities of March 1, 2025 – March 1, 2042. The Board has not had to perform on any loan guarantee in the past. The amounts are merely commitments of the Board.

By statute, the Board is authorized to credit enhance the INTERCAP bonds and allows the Board to charge a fee for this service. There is an annual fee of up to 15 basis points on outstanding INTERCAP bonds. If the Board was called on to purchase tendered bonds not redeemed or remarketed, INTERCAP’s governing bond indenture requires the Board to be paid a fee equal to 25 basis points of the principal amount

tendered bonds purchased. The credit enhancement fee received during the fiscal year was \$162 thousand.

MFFA is a discretely presented component unit of the State of Montana. MFFA guarantee requests are submitted to the Board for review and approval. The Board’s participation, either duration or any other consideration, to either purchase bonds or loans or to lend money for deposit into MFFA’s statutorily allowed capital reserve account is explicitly limited by statute which requires the Board to act prudently. The guarantee requests from MFFA pertain to bonds issued by MFFA with a term of up to 40 years. The Board receives a credit enhancement fee at MFFA bond closing based on the term of the financing, the type of bond, the rating of the borrower, and the type of reserve fund. The Board and MFFA have entered into an agreement detailing repayment to the Board. The credit enhancement fee received during the fiscal year was \$449 thousand.

The following schedule summarizes the guarantee activity during the fiscal year:

Bond and Loan Guarantee Activity as of June 30, 2018 (in thousands)				
	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>
INTERCAP	\$ 107,880	\$ -	\$ 2,770	\$ 105,110
MFFA	71,416	36,470	26,435	81,451

## 13. STIP RESERVE

In November 2007, a reserve account was established for STIP. The reserve account may be used to offset losses within the STIP portfolio. The STIP Reserve is detailed as follows for the year ending June 30<sup>th</sup>:

STIP Reserve Activity as of June 30, 2018 (in thousands)	
Beginning STIP Reserve	\$ 24,235
STIP Reserve activity	
Additions	
Interest income	350
Other investment income:	
Transfer of daily STIP income	4,192
Recoveries from write offs	3,626
Perm Coal enhancement fees	162
Total other investment income	<u>7,980</u>
Total additions	<u>8,330</u>
Total STIP Reserve activity	<u>8,330</u>
Ending STIP Reserve	<u><u>\$ 32,565</u></u>

## 14. SUBSEQUENT EVENTS

In November 2017, the Governor called the Montana legislature into special session to address a significant budget shortfall in the State's general fund. Senate Bill 4 was passed into law and directed the Board to apply a 3% charge against the average total investments of the State Fund exceeding \$1 billion providing certain conditions are met. The Board is directed to transfer money from this charge on or before April 2019 to the State's Fire Suppression Fund. A lawsuit was filed by a group of Montana State Fund policyholders, to prevent the Board from charging the 3% management fee. Motions to dismiss are currently pending before Judge Larson sitting by designation in the 20<sup>th</sup> Judicial District.

On July 6, 2018, the Board terminated one manager in the Domestic Equity Asset within CAPP. The approximate market value of the transition was \$80 million.

In August based on Board action, the Board approved an additional loan guarantee from the Coal Severance Tax Permanent Fund to Montana Facility Finance Authority totaling \$11 million. The Board also directed the TFIP purchase of the Montana direct real estate owned within CAPP for \$19.4 million.

On September 28, 2018, the Board sold several Private Equity Asset Class limited partnerships within CAPP to an outside 3<sup>rd</sup> party in a secondary sale. The proceeds of the sales were approximately \$50 million.



The Board's Executive Director retired September 28, 2018 and a new Executive Director started September 29, 2018. The Board's Deputy Executive Director retired November 23, 2018.

On October 16, 2018, the Board reallocated assets in the Domestic Equity Asset Class within CAPP from a commingled fund to a new manager. The approximate market value of the transition was \$500 million.

Since June 30, 2018, the Board has committed an additional \$200 million to alternative equity partnerships within CAPP, with allocations of \$80 million within the Private Equity Asset Class, \$40 million within the Natural Resource Asset Class and \$80million within the Real Estate Asset Class. Refer to Note 3 – Investment Commitments for further detail.

Since June 30, 2018, the Board has received an additional \$16.7 million in loan reservations from Montana Lenders and committed to \$435 thousand in loans from the Coal Severance Tax Permanent Fund. Refer to Note 9 – Coal Severance Tax Trust Fund Loan and Mortgage Commitments for further detail.

During fiscal year 2017, the Board requested a 100% redemption in the amount of \$174 million from one manager, pertaining to investments from CAPP, TFIP, and SMI. Since June 30, 2017, total redemptions in the amount of \$116.4 million have been received, of which \$10.6 million was received since June 30, 2018. The Board is confident that the full redemption will be received over a reasonable time period.

Since June 30, 2018, the Board has received recovery payments associated with the recovery of previously written off losses in the amount of \$1.8 million and \$270 thousand interest. Refer to Note 13 – STIP Reserve for further detail.



**SUPPLEMENTARY INFORMATION**

COMBINING STATEMENT OF FIDUCIARY NET POSITION  
 FOR FISCAL YEAR ENDING JUNE 30, 2018  
 (in thousands)

Assets	TFIP				
	Total	CAPP	State Agencies	Local Governments	SMI
Investments:					
Cash and cash equivalents:					
Cash equivalent/STIP at fair value - held within pools	\$ -	\$ 80,323	\$ 30,675	\$ 158	\$ -
Cash and cash equivalents held at custodial bank	<u>2,585,318</u>	<u>334,649</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total cash and cash equivalents	<u>2,585,318</u>	<u>414,972</u>	<u>30,675</u>	<u>158</u>	<u>-</u>
Investments at cost	180,618	-	-	-	180,618
Investments at fair value	<u>15,836,058</u>	<u>10,900,371</u>	<u>2,290,404</u>	<u>11,833</u>	<u>1,552,894</u>
Total investments	<u>18,601,994</u>	<u>11,315,343</u>	<u>2,321,079</u>	<u>11,991</u>	<u>1,733,512</u>
Securities lending cash collateral	<u>120,583</u>	<u>73,608</u>	<u>32,416</u>	<u>167</u>	<u>14,392</u>
Receivables:					
Broker receivable for securities sold but not settled	28,321	28,321	-	-	-
Dividend and interest receivable	<u>52,590</u>	<u>26,381</u>	<u>13,568</u>	<u>70</u>	<u>8,600</u>
Total receivables	<u>80,911</u>	<u>54,702</u>	<u>13,568</u>	<u>70</u>	<u>8,600</u>
 Total assets	 <u>18,803,488</u>	 <u>11,443,653</u>	 <u>2,367,063</u>	 <u>12,228</u>	 <u>1,756,504</u>
Liabilities					
Payables:					
Broker payable for securities purchased but not settled	50,955	50,955	-	-	-
Income due participants	20,774	-	6,475	33	8,600
Other payable	5,526	5,526	-	-	-
Administrative fee payable	4,753	4,707	46	-	-
Securities lending obligations	<u>120,583</u>	<u>73,608</u>	<u>32,416</u>	<u>167</u>	<u>14,392</u>
Total liabilities	<u>202,591</u>	<u>134,796</u>	<u>38,937</u>	<u>200</u>	<u>22,992</u>
 Net position held in trust for pool and SMI participants	 <u>\$ 18,600,897</u>	 <u>\$ 11,308,857</u>	 <u>\$ 2,328,126</u>	 <u>\$ 12,028</u>	 <u>\$ 1,733,512</u>

Statements continue onto the next page.

COMBINING STATEMENT OF FIDUCIARY NET POSITION  
FOR FISCAL YEAR ENDING JUNE 30, 2018  
(in thousands)

Assets	STIP			Reserve included in STIP**	STIP included in investment pools*
	State Agencies	Local Governments	Reserve		
Investments:					
Cash and cash equivalents:					
Cash equivalent/STIP at fair value - held within pools	\$ -	\$ -	\$ -	\$ -	\$ (111,156)
Cash and cash equivalents held at custodial bank	<u>1,396,483</u>	<u>821,667</u>	<u>32,519</u>	-	-
Total cash and cash equivalents	<u>1,396,483</u>	<u>821,667</u>	<u>32,519</u>	-	<u>(111,156)</u>
Investments at cost	-	-	-	-	-
Investments at fair value	<u>680,287</u>	<u>400,269</u>	-	-	-
Total investments	<u>2,076,770</u>	<u>1,221,936</u>	<u>32,519</u>	-	<u>(111,156)</u>
Securities lending cash collateral	-	-	-	-	-
Receivables:					
Broker receivable for securities sold but not settled	-	-	-	-	-
Dividend and interest receivable	<u>2,471</u>	<u>1,454</u>	<u>46</u>	-	-
Total receivables	<u>2,471</u>	<u>1,454</u>	<u>46</u>	-	-
 Total assets	 <u>2,079,241</u>	 <u>1,223,390</u>	 <u>32,565</u>	 -	 <u>(111,156)</u>
Liabilities					
Payables:					
Broker payable for securities purchased but not settled	-	-	-	-	-
Income due participants	3,567	2,099	-	-	-
Other payable	-	-	-	-	-
Administrative fee payable	-	-	-	-	-
Securities lending obligations	-	-	-	-	-
Total liabilities	<u>3,567</u>	<u>2,099</u>	-	-	-
 Net position held in trust for pool and SMI participants	 <u>\$ 2,075,674</u>	 <u>\$ 1,221,291</u>	 <u>\$ 32,565</u>	 <u>\$ -</u>	 <u>\$ (111,156)</u>

\*STIP holdings, purchases, sales, and investment earnings within investment pools are offset to calculate a combining total.

\*\*STIP Reserve investment earnings and reserve expense within STIP are offset to calculate a combining total.

COMBINING STATEMENT OF CHANGES IN FIDUCIARY NET POSITION  
FOR FISCAL YEAR ENDING JUNE 30, 2018  
(in thousands)

	Total	CAPP	TFIP		SMI
			State Agencies	Local Governments	
Additions					
Purchases by participants	\$ 7,884,031	\$ 64,907	\$ 97,312	\$ -	\$ 592,448
Net investment earnings					
Investment earnings:					
Net increase (decrease) on fair value of investments	769,871	820,260	(70,218)	(369)	(11,133)
Dividend/interest income	344,589	203,118	78,329	415	44,152
Other investment income	3,789	-	1	-	-
Investment earnings	1,118,249	1,023,378	8,112	46	33,019
Administrative expenses	(57,117)	(52,813)	(2,094)	(11)	(1,495)
Other investment expenses	(17,196)	(17,188)	(6)	-	(2)
Short Term Investment Pool reserve expense	-	-	-	-	-
Net investment income	1,043,936	953,377	6,012	35	31,522
Securities lending income	3,066	2,172	499	3	392
Securities lending expense	(1,313)	(838)	(240)	(1)	(234)
Net securities lending income	1,753	1,334	259	2	158
Total additions	8,929,720	1,019,618	103,583	37	624,128
Deductions					
Sales by participants	7,796,023	347,853	20,993	377	678,623
Income distributions to participants	191,442	-	76,007	403	70,137
Total deductions	7,987,465	347,853	97,000	780	748,760
Change in net position	942,255	671,765	6,583	(743)	(124,632)
Net position held in trust for pool and SMI participants - beginning of year	17,634,407	10,637,092	2,321,543	12,771	1,858,144
Adjustment to beginning net position (Note 2)	24,235	-	-	-	-
Beginning of the year net position - as adjusted	17,658,642	10,637,092	2,321,543	12,771	1,858,144
Net position held in trust for pool and SMI participants - end of year	\$ 18,600,897	\$ 11,308,857	\$ 2,328,126	\$ 12,028	\$ 1,733,512

Statements continue onto the next page.

COMBINING STATEMENT OF CHANGES IN FIDUCIARY NET POSITION  
FOR FISCAL YEAR ENDING JUNE 30, 2018  
(in thousands)

	STIP			Reserve included in STIP**	STIP included in investment pools*
	State Agencies	Local Governments	Reserve		
Additions					
Purchases by participants	\$ 6,539,802	\$ 1,503,547	\$ -	\$ -	\$ (913,985)
Net investment earnings					
Investment earnings:					
Net increase (decrease) on fair value of investments	19,785	11,527	-	-	19
Dividend/interest income	13,398	7,795	350	(350)	(2,618)
Other investment income	2,395	1,393	7,980	(7,980)	-
Investment earnings	35,578	20,715	8,330	(8,330)	(2,599)
Administrative expenses	(445)	(259)	-	-	-
Other investment expenses	-	-	-	-	-
Short Term Investment Pool reserve expense	(5,266)	(3,064)	-	8,330	-
Net investment income	29,867	17,392	8,330	-	(2,599)
Securities lending income	-	-	-	-	-
Securities lending expense	-	-	-	-	-
Net securities lending income	-	-	-	-	-
Total additions	6,569,669	1,520,939	8,330	-	(916,584)
Deductions					
Sales by participants	6,392,545	1,315,574	-	-	(959,942)
Income distributions to participants	30,036	17,477	-	-	(2,618)
Total deductions	6,422,581	1,333,051	-	-	(962,560)
Change in net position	147,088	187,888	8,330	-	45,976
Net position held in trust for pool and SMI participants - beginning of year	1,928,586	1,033,403	-	-	(157,132)
Adjustment to beginning net position (Note 2)	-	-	24,235	-	-
Beginning of the year net position - as adjusted	1,928,586	1,033,403	24,235	-	(157,132)
Net position held in trust for pool and SMI participants - end of year	\$ 2,075,674	\$ 1,221,291	\$ 32,565	\$ -	\$ (111,156)

\*STIP holdings, purchases, sales, and investment earnings within investment pools are offset to calculate a combining total.

\*\*STIP Reserve investment earnings and reserve expense within STIP are offset to calculate a combining total.





# **Independent Auditor's Report and Enterprise Fund Program Financial Statements**



Angus Maciver, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors  
Cindy Jorgenson  
Joe Murray

## INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

### *Introduction*

We have audited the accompanying Statement of Net Position of the Montana Board of Investments' (board) Enterprise Fund Program as of June 30, 2018, the related Statement of Revenues, Expenses and Changes in Net Position, and Statement of Cash Flows for the fiscal year then ended, and the related notes to the financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this responsibility includes designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the board's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the board's internal control, and accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion the financial statements referred to above present fairly, in all material respects, the financial position of the Montana Board of Investments' Enterprise Fund Program as of June 30, 2018, and the changes in net position and cash flows for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

### *Emphasis of Matter*

As discussed on page A-55 in the notes to the financial statements, the Montana Board of Investments' Enterprise Fund Program financial statements are intended to present the financial position, changes in net position, and cash flows of only the portion of the financial reporting entity of the state of Montana that are attributed to the transactions of the Enterprise Fund Program at the board. They do not purport to, and do not present fairly the financial position of the state of Montana as of June 30, 2018, or the changes in its financial position and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

As discussed on page A-57, in fiscal year 2018, the Montana Board of Investments elected to change its method of valuing cash equivalents, from fair value to cost. As a result of this change, the amount of activity disclosed in the fair value note disclosures is different than that of prior years. Our opinion is not modified with respect to this matter.

### *Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on page A-46, the Schedule of Net Pension Liability on page A-75, the Schedule of Contributions on page A-75, and the Schedule of Total OPEB Liability on page A-76 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

*Other Reporting Required by Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 7, 2018, on our consideration of the Montana Board of Investments' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the board's internal control over financial reporting and compliance.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA  
Deputy Legislative Auditor  
Helena, MT

December 7, 2018

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

This Management's Discussion and Analysis for the Enterprise Fund (the Fund) of the Board of Investments (the Board) of the State of Montana (the State) is presented as an introduction to the financial statements of the Fund. It is meant to assist the reader in understanding the financial statements by providing an overall review of the financial activities during the year, as well as to provide a comparison to the prior year's activities and results.

In addition to the Fund, the Board also administers the Unified Investment Program (UIP) to account for investing activities for local governments, component units, and state agencies. This section of the report represents only the Fund. The UIP financial statements are presented separately.

### **Financial Highlights**

The Fund's total net position for both fiscal years ending June 30, 2018 and June 30, 2017 were approximately \$5.1 million. The net position increased \$25 thousand for the year ended June 30, 2018 as compared to June 30, 2017.

Operating revenue of the Fund increased for the year ending June 30, 2018 to \$2.6 million as compared to \$1.8 million in the prior year. This was primarily due to an increase in financing income in the amount of \$637 thousand.

Operating expenses of the Fund increased for the year to \$2.6 million as compared to \$1.9 million in the prior year. This increase in expenses was primarily the result of higher interest paid on outstanding bonds in the amount of \$665 thousand and an increase of \$135 thousand in contracted services primarily related to the new INTERCAP Revolving Loan Program (INTERCAP) computer system.

The net of operating revenue and operating expenses resulted in an operating loss for the Fund for the year of approximately \$57 thousand. This is in comparison to an operating loss of approximately \$67 thousand in the previous fiscal year.

Cash flow of the Fund increased by approximately \$17.4 million for the fiscal year as compared to a net decrease in cash flow of approximately \$7.2 million in the prior fiscal year. During fiscal year 2018, the loans funded were in the amount of \$20.6 million as compared to \$46.7 million in the prior year. The prior year had an out of the ordinary influx in municipal infrastructure and university project financing. The outflow for payment of principal and interest on bonds was \$4.5 million in 2018 as compared to \$10.4 million in 2017. Regarding the Series 98 bond, \$9.0 million was paid down during fiscal year 2017 and the remaining \$2.8 million was paid at final maturity in fiscal year 2018. Collections for principal and interest on loans also increased by \$2.4 million in 2018 as compared to 2017.

### **Overview of the Financial Statements**

The Fund is a Proprietary Fund of the State's Comprehensive Annual Financial Report (CAFR), which is separately issued from these financial statements. The Fund is not an entire reporting entity as described within accounting principles generally accepted in the United States of America (GAAP) as established by the Governmental Accounting Standards Board (GASB). However, the Fund provides this report to account for State programs created under the Municipal Finance Consolidation Act and Economic Development Bond Act of the State.

The financial statements and footnotes follow this section of the report. The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting in accordance with GAAP.

The **Statement of Net Position** provides information on the assets, deferred outflows of resources, liabilities, deferred inflows of resources, and the elements of Net Position of the Fund as of the fiscal year ended June 30, 2018.

The **Statement of Revenues, Expenses and Changes in Net Position** provides information on the various flows of operating revenues, operating expenses, non-operating revenues, and non-operating expenses for the Fund for the fiscal year ended June 30, 2018.

The **Statement of Cash Flows** presents information on the sources and uses of cash during the most recent fiscal year. The Statement of Cash Flows is subdivided into three major sections to show cash provided or used by operating, capital and related financing, and investing activities. GAAP requires this statement to be reported utilizing a direct relationship of cash to sources of flows with a reconciliation of net cash provided by or used for operating activities to net operating income. A further schedule is also provided for non-cash transactions, primarily relating to the increase or decrease in the fair value of the Fund's investments that occurred during the fiscal year but did not result in cash flows.

The **Notes to the Basic Financial Statements** provide additional information that is essential to a full understanding of the data provided in the financial statements of the Fund.

Additional **Required Supplementary Information** is presented in accordance with GAAP related to the defined benefit pensions and other postemployment benefits (OPEB).

### Financial Analysis

*Net Position.* The following is a condensed Statement of Net Position of the Fund as of June 30, 2018 as compared to the prior year:

<b>Condensed Statement of Net Position</b> (in thousands)	<b>As of June 30,</b>	
	<b><u>2018</u></b>	<b><u>2017</u></b>
<b>Assets</b>		
Non-capital assets	\$113,120	\$113,915
Capital assets, net of accumulated depreciation	<u>1</u>	<u>1</u>
<b>Total Assets</b>	<b>113,121</b>	<b>113,916</b>
<b>Deferred Outflows of Resources</b>	<b>90</b>	<b>64</b>
<b>Liabilities</b>		
Current liabilities	105,747	108,372
Noncurrent liabilities	<u>2,338</u>	<u>523</u>
<b>Total Liabilities</b>	<b>108,085</b>	<b>108,895</b>
<b>Deferred Inflows of Resources</b>	<b>17</b>	<b>1</b>
<b>Net Position:</b>		
Invested in Capital Assets	1	1
Restricted Net Position	1,368	1,522
Unrestricted Net Position	<u>3,740</u>	<u>3,561</u>
<b>Total Net Position</b>	<b><u>\$5,109</u></b>	<b><u>\$5,084</u></b>

As of June 30, 2018, most of the assets remained composed of note and loan interest and principal receivable in accordance with the INTERCAP program presented in the Fund. As described in more detail in the notes to the basic financial statements, the Fund issues notes and loans for eligible Montana local governments, state agencies, and component units.

At the end of the fiscal year, the total note and loan principal portfolio receivable was approximately \$81.0 million, as compared to approximately \$94.7 million at the beginning of the year. Approximately \$20.6 million in loans were funded during the fiscal year ended June 30, 2018. The Fund received repayments of approximately \$36.3 million, including principal and interest. None of the portfolio is considered in default as of the end of the fiscal year.

The remaining assets are comprised of cash and cash equivalents, interest receivable related to investments and investments at fair value. As described in the Notes to the basic financial statements, most of the fair value of investments are held in either United States Treasury securities, United States government indirect obligations or similar funds utilizing a short duration and minimal risk.

Deferred outflows of resources and deferred inflows of resources are related to various elements of defined benefit pensions and OPEB that are recognized as part of future years' expenses due to the passage of time. The prior period adjustment increased the beginning net position by \$76 thousand. The change was the result of an increase of net pension liability of \$34 thousand, an increase of deferred pension inflows of \$14 thousand, an increase of pension deferred outflows of \$2 thousand, an increase of pension expense of \$51 thousand, an increase of non-employer pension revenue of \$6 thousand, a decrease to OPEB liability of \$71 thousand, and an increase of cash equivalents of \$6 thousand.

Most of the Fund's liabilities are bonds payable related to debt issuances that fund the INTERCAP loans for eligible Montana governmental units. As discussed in the Notes to the basic financial statements, the amounts are deemed current liabilities as they may be payable on demand each March 1<sup>st</sup> prior to final maturity in 2042.

The total net position of the Fund is comprised of three elements as required by GAAP. Unrestricted Net Position is the largest element that represents the accumulated unrestricted changes in net position since the inception of the Fund. Restricted Net Position is comprised of amounts related to Montana Economic Development Bonds and the Conservation Reserve Enhancement Program. Restricted net position can only be reused in accordance with those provisions. The amount invested in capital assets changed during the year for depreciation.

*Changes in Net Position.* The following is a condensed Statement of Revenues, Expenses and Changes in Net Position by major sources for the current and prior fiscal years ended June 30.

<b>Condensed Statement of Revenues, Expenses and Changes in Net Position</b> (in thousands)	<b>Fiscal Years Ended June 30,</b>	
	<b><u>2018</u></b>	<b><u>2017</u></b>
<b>Operating Revenues</b>		
Financing Income	\$2,304	\$1,667
Other	<u>287</u>	<u>118</u>
<b>Total Operating Revenues</b>	<b>2,591</b>	<b>1,785</b>
<b>Operating Expenses</b>		
Debt Service	1,906	1,241
Personal Services	381	387
Other	<u>361</u>	<u>224</u>
<b>Total Operating Expenses</b>	<b><u>2,648</u></b>	<b><u>1,852</u></b>
<b>Operating Income (Loss)</b>	<b>(57)</b>	<b>(67)</b>
<b>Nonoperating Income (Loss)</b>		
NonEmployer Pension (Expense) Revenue	<u>6</u>	<u>7</u>
<b>Change in Fund Net Position</b>	<b><u>(51)</u></b>	<b><u>(60)</u></b>
<b>Total Fund Net Position as of the Beginning of the Year</b>	<b>5,084</b>	<b>5,177</b>
<b>Restatement</b>	<b><u>76</u></b>	<b><u>(33)</u></b>
<b>Total Fund Net Position as of the Beginning of the Year, Restated</b>	<b><u>5,160</u></b>	<b><u>5,144</u></b>
<b>Total Fund Net Position as of the End of Year</b>	<b><u>\$5,109</u></b>	<b><u>\$5,084</u></b>



Operating revenues were primarily related to financing income related to the INTERCAP note and loan portfolio. Financing income primarily increased from the prior year due to the borrower interest rate increasing in February 2018 to 3.15% from 2.50% and increasing in February 2017 to 2.50% from 1.55%. Other operating revenues are comprised of investment income, primarily from investment interest and changes in fair value.

Operating expenses occur in two areas: debt service and personal services. Debt service on the bonds includes interest expense, trustee fees and similar, which increased this year because of higher interest rates. Personal services include employee compensation, compensated absence expense, sick leave and other compensatory time recognized during the fiscal year. These amounts decreased this year due to the Bond Program Office not being fully staffed. Such amounts are part of a legislatively approved rate and a Board approved budget.

Other amounts include contracted services, supplies and materials, communications, travel, rent, pensions, postemployment benefits, and other overhead expenses. These expenses increased during the year because of a computer system for INTERCAP.

The net of all the flows resulted in a \$180 thousand increase to Unrestricted Net Position for the fiscal year ended June 30, 2018 and a \$154 thousand decrease to Restricted Net Position. This compares to a decrease of approximately \$93 thousand in Total Net Position in the prior year.

#### **Economic Factors and Currently Known Facts that may Impact the Fund's Operations in the Future**

The Board's 25-year tax-exempt Municipal Finance Consolidated Act Bonds used to fund low variable interest rate loans through INTERCAP provide bondholders with an annual tender option that, if tendered, are remarketed every February. Market conditions that include, but are not limited to, supply and demand along with other similar rated credits pricing at the time of remarketing influence the bond yield negotiated each year.

*GASB Statement No. 88 Certain Disclosures Related to Debt, Including Direct Borrowings and Direct Placements* will be implemented during the upcoming fiscal year. The Board's management is in the process of analyzing the changes that potentially may occur to the financial statements related to this issuance as the GASB-88 redefines the word 'debt.' Perhaps more importantly, after year end, the GASB issued an exposure draft *Conduit Debt Obligations* potentially changing the status of the Fund's reporting of qualified zone academy bonds and qualified school construction bonds, which are currently deemed conduit debt. If approved by the GASB as proposed, any change in conduit debt reporting may not occur until the fiscal year ending June 30, 2022.

*Requests for Information and Transparency.* This financial report is designed to provide a general overview of the Fund's operations. Questions concerning any of the information contained in this report or requests for additional information about the Board's operations, should be addressed to the Board at 2401 Colonial Drive, 3<sup>rd</sup> Floor, PO Box 200126, Helena, Montana 59620-0126. The Board may be reached by phone at 406.444.0001, fax at 406.449.6579 or TDD at 406.841.2702. Board Meeting agenda and minutes are posted at <http://investmentmt.com/meetings>.

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STATEMENT OF NET POSITION AS OF JUNE 30, 2018 (in thousands)	
<b>Assets</b>	
Current assets:	
Cash and cash equivalents	\$ 24,085
Interest receivable	557
Notes/loans receivable	10,118
Other receivable	263
Interfund notes/loans	3,222
Interfund interest receivable	93
Component Unit notes/loans	2,723
Component Unit interest receivable	270
Short-term investments at fair value	4,262
Prepaid expense	5
Total current assets	45,598
Noncurrent assets:	
Restricted investments at fair value	685
Notes/loans receivable	38,692
Interfund notes/loans and interest receivable	5,555
Component Unit notes/loans receivable	20,736
Property held in custody for others	1,854
Equipment	4
Accumulated depreciation	(3)
Total noncurrent assets	67,523
Total assets	113,121
Deferred outflows of resources	90
<b>Liabilities</b>	
Current liabilities:	
Accrued expenses	26
Accrued interest payable	578
Compensated absences	33
Current bonds/notes payable	105,110
Total current liabilities	105,747
Noncurrent liabilities	
Compensated absences	29
Arbitrage rebate tax payable	17
Total OPEB liability	19
Held in custody for others	1,854
Net pension liability	419
Total noncurrent liabilities	2,338
Total liabilities	108,085
Deferred inflows of resources	17
<b>Net position</b>	
Net investment in capital assets	1
Restricted	1,368
Unrestricted	3,740
Total net position	\$ 5,109
The accompanying notes are an integral part of these financial statements.	

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET POSITION FOR THE FISCAL YEAR ENDED JUNE 30, 2018 (in thousands)	
Operating revenue	
Reimbursements	\$ 37
Investment revenue	250
Financing revenue	2,304
Total operating revenue	2,591
Operating expenses	
Personal services	381
Contracted services	167
Supplies and materials	9
Communications	13
Travel	4
Rent	51
Indirect and other costs	65
OPEB expense	1
Pension expense	51
Depreciation expense	1
Arbitrage rebate tax expense	(1)
Debt service	
Interest expense	1,441
Trustee fee expense	76
Credit enhancement fee	162
Other debt service expense	227
Total operating expenses	2,648
Operating income (loss)	(57)
Nonoperating revenue	
Non-employer pension revenue	6
Nonoperating income (loss)	6
Change in fund net position	(51)
Total fund net position, July 1, as previously reported	5,084
Prior period adjustment (Note 2)	76
Total fund net position, July 1, as restated	5,160
Total fund net position, June 30	\$ 5,109
The accompanying notes are an integral part of these financial statements.	

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED JUNE 30, 2018 (in thousands)	
Cash flows from operating activities:	
Reimbursements	\$ 37
Payments to suppliers for goods and services	(311)
Payments to employees	(430)
Net cash (used for) operating activities	(704)
Cash flows from non-capital financing activities:	
Payment of principal and interest on bonds and notes	(4,529)
Proceeds from issuance of bonds and notes	0
Non-employer pension revenue	6
Net cash (used for) provided by non-capital financing activities	(4,523)
Cash flows from capital and related financing activities:	
Acquisition of fixed assets	0
Net cash (used for) capital and related financing activities	0
Cash flows from investing activities:	
Collections for principal and interest on loans	36,265
Cash payments for loans	(20,630)
Purchase of investments	(4,235)
Proceeds from sales or maturities of investments	10,917
Interest on deposits/investments	296
Net cash (used for) provided by investing activities	22,613
Net (decrease) increase in cash and cash equivalents	17,386
Cash and cash equivalents, July 1	6,699
Cash and cash equivalents, June 30	\$ 24,085

Statement continued on next page.

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED JUNE 30, 2018  
(in thousands)

Reconciliation of net income to net cash (used for) operating activities:	
Net operating income (loss)	\$ (57)
Adjustments to reconcile net income to net cash (used for) operating activities	
Depreciation	1
Non-employer pension revenue	6
Interest on investments	(250)
Financing income	(2,304)
Interest expense	1,906
Arbitrage rebate tax expense	(1)
Change in assets, liabilities, deferred inflows, and deferred outflows:	
Decrease (increase) in other assets	(5)
Decrease (increase) in other receivables	51
Decrease (increase) in pension deferred outflows (Notes 11, 14)	(25)
Increase (decrease) in accounts payable	(2)
Increase (decrease) in arbitrage payable	(6)
Increase (decrease) in other payables	2
Increase (decrease) in net pension liability	34
Increase (decrease) in OPEB liability	(70)
Increase (decrease) in OPEB deferred inflows of resources	2
Increase (decrease) in pension deferred inflows of resources	14
Total adjustments	(647)
Net cash (used for) operating activities	(704)
Schedule of noncash transactions:	
Increase/(decrease) in fair value of investments	14
Total noncash transactions	\$ 14
The accompanying notes are an integral part of these financial statements.	

## **NOTES TO THE FINANCIAL STATEMENTS FOR THE FISCAL YEAR ENDED JUNE 30, 2018**

These financial statements present only the activity of the Enterprise Fund (the Fund) as managed by the Board of Investments (the Board). The Fund is reported as a proprietary fund within the State of Montana's (the State) Comprehensive Annual Financial Report (the CAFR). The State's CAFR is available from the Montana Department of Administration's State Financial Services Division website <http://sfsd.mt.gov/SAB/cafr>; at Room 255 Mitchell Building, 125 North Roberts Street, PO Box 200102, Helena, MT 59620-0102 or at 406-444-3092.

### **1. DESCRIPTION OF FUND AND SIGNIFICANT ACCOUNTING POLICIES**

#### **DESCRIPTION OF FUND**

The Board uses the Fund to account for its programs created under the Municipal Finance Consolidation Act and the Economic Development Bond Act.

Municipal Finance Consolidation Act programs include:

- The INTERCAP Revolving Loan Program (INTERCAP) provides funds to eligible Montana state and local governments to finance capital expenditures for up to fifteen years or the useful life of the project, whichever is less.
- Qualified Zone Academy Bond (QZAB) Program provides a financial instrument that is a different form of subsidy from traditional tax-exempt bonds. The federal government pays the interest on the QZABs in the form of an annual tax credit to a bank (or other eligible financial institution) that holds the QZAB. The Board acts as a legal funding conduit only and is not liable for the repayment of the bonds.
- Qualified School Construction Bond (QSCB) Program provides a financial instrument that is a different form of subsidy from traditional tax-exempt bonds. The revenues of the borrower are pledged to repay the bonds. The Board acts as a legal funding conduit only and is not liable for the repayment of the bonds.

Economic Development Bond Act programs include:

- The Conservation Reserve Enhancement Program (CRP), created in 1990 by issuing bonds, allows farmers to receive a lump sum payment by assigning their federal CRP contract to the Board. The farmers under contract must comply with seeding and other requirements.

#### **BASIS OF ACCOUNTING**

The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, expenses are recorded when incurred and revenues are recorded when earned. The financial statements are prepared from the Statewide Accounting, Budgeting, and Human Resource System (SABHRS) and information contained in the bond trustee statements.

#### **CASH AND CASH EQUIVALENTS**

Cash and cash equivalents are generally short-term, highly liquid investments with maturities of three months or less at time of purchase and are reported at cost. Amortized cost, or carrying value, represents the original cost, adjusted for premium and discount amortization where applicable. Premiums and discounts are amortized/accreted using the straight-line method to the maturity date of the securities. For additional detail, see Note 3 – Cash and Investments.

#### **INVESTMENTS**

Investments are presented in the Statement of Net Position at fair value. Investment fair values for publicly traded securities are determined primarily by reference to market prices supplied by the Board's trustee. For further detail, see Note 3 – Cash and Investments.

RECEIVABLES

Receivables primarily represent notes and loans classified in three categories as follows:

- 1) Notes and loans receivable from local governments.
- 2) Interfund notes and loans receivable from state agency governments.
- 3) Component Unit notes and loans receivable from university units for which the State is financially accountable.

Notes and loans generally have terms of less than 15 years. For additional detail, see Note 4 - Receivables.

CAPITAL ASSETS AND DEPRECIATION

Capital assets include equipment with a cost of \$5 thousand or more. Capital assets are valued at historical cost. In accordance with state policy, the capital assets are depreciated on a straight-line methodology over an estimated useful life of 5 - 10 years. The capital assets within the fund represent equipment. Assets less than \$5 thousand at time of acquisition are expensed.

ARBITRAGE REBATE

The amount of investment income the Fund may earn and retain on the proceeds of various bonds is limited by federal tax law. Earnings more than the allowable amount must be rebated to the United States Treasury. As of June 30, 2018, \$17 thousand of such excess earnings are recorded as part of liabilities.

COMPENSATED ABSENCES

Compensated absences reflect the accrued benefits due to employees at the end of the fiscal year.

PENSIONS AND OTHER POSTEMPLOYMENT BENEFITS (OPEB)

For the purposes of measuring the net pension liability and the net OPEB liabilities, deferred outflows of resources, and deferred inflows of resources related to pensions and OPEB, respectively and pension and OPEB expense, respectively, information about the fiduciary net position of the Montana Public Employees Retirement Association (MPERA) and the State Group Benefits Plan administered by the Montana Department of Administration, along with additions to and deductions from fiduciary net position have been determined on the same basis as those systems. For this purpose, benefit payments, including refunds of employee contributions, are recognized when due and payable in accordance with the benefit terms. For additional detail, see Notes 9 – Pensions and 10 – OPEB.

NET POSITION

Net Position represents the accumulated net profits of the Fund's programs. The programs except for Montana Economic Development Bonds (MEDB), Guarantee Fund Account, MEDB Guarantee CRP Note Reserve, MEDB Contingency Account, and CRP are restricted under bond indentures governing the use of these funds.

OPERATING AND NONOPERATING REVENUES AND EXPENSES

Operating revenues reflect interest income on loans and investments, change in fair value of investments, and directly related investment expenses offsetting investment income. Operating expenses include interest expense, general and administrative expenses. All revenues and expenses not meeting this definition are nonoperating.

USE OF ESTIMATES

The preparation of the basic financial statements in conformity with Generally Accepted Accounting Principles (GAAP) applicable in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, along with required disclosure as of the date of the financial statements. Actual amounts may differ from those estimates.



## 2. OTHER ACCOUNTING CHANGES

### PRIOR PERIOD ADJUSTMENT

The prior period adjustment was an increase to the beginning net position by \$76 thousand, which was the result of an increase of Net Pension Liability of \$34 thousand, an increase of Deferred Pension Inflows of \$14 thousand, an increase of Pension Deferred Outflows of \$2 thousand, an increase of Pension Expense of \$51 thousand, an increase of Nonemployer Pension Revenue of \$6 thousand, a decrease to OPEB Liability of \$71 thousand, and an increase of cash equivalents of \$6 thousand.

### NEW ACCOUNTING GUIDANCE IMPLEMENTED

For the year ended June 30, 2018, the Board implemented GASB 75 – Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions and the related amendments contained in GASB 85 – Omnibus 2017. These Statements establish standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures. For defined benefit OPEB, this Statement identifies the methods and assumptions that are required to be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. Note disclosure and required supplementary information requirements about defined benefit OPEB also are addressed.

### CASH AND CASH EQUIVALENTS – CHANGE IN VALUATION METHOD

During the fiscal year ended June 30, 2018, the Board reevaluated the measurement of cash and cash equivalents and aligned reporting of such investments at cost. Under GASB, cash equivalents can be reported under either the fair value or cost basis. The Board analyzed the immaterial difference in cash equivalents between their fair value and cost and determined the more relevant disclosure was under the cost method. Such a change did not cause a restatement of beginning net position due to the immaterial impact on beginning net position.

## 3. CASH AND INVESTMENTS

### CASH AND CASH EQUIVALENTS

Cash and cash equivalents, as identified in the Statement of Net Position, are as follows:

Cash and Cash Equivalents (in thousands)		June 30, 2018
Cash in treasury	\$	10
Short Term Investment Pool (STIP)		95
First American Government Obligation Fund		757
U.S. Treasury Bills		23,223
Total Cash and Cash Equivalents	\$	<u>24,085</u>

The Fund invests its operational cash in the Board's Short-Term Investment Pool (STIP), an external investment pool. STIP is managed to preserve principal while providing 24-hour liquidity for state agencies, component units, and local government participants. Funds may be invested for one or more days. The STIP investments and the income are owned by the participants and are managed on their behalf by the Board. Cash and cash equivalents are reported at cost.

### INVESTMENTS AND INVESTMENT RISKS

The Fund deposits and investments are restricted by the bond trust indenture to the following: government and agency obligations, certificates of deposits, repurchase agreements, and investment agreements. The bond trust indenture addresses custodial credit risk, concentration of credit risk, credit risk, interest rate and credit quality risk by detailing the permitted investments. The Board's STIP Investment Policy Statement (IPS) details custodial credit risk, concentration of credit risk, and credit risk. Deposits and investments must be made with Montana banks or in

the STIP administered by the Board.

#### CUSTODIAL CREDIT RISK

Custodial credit risk is the risk that, in the event of the failure of the counterparty to a transaction, the Board will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. Per policy, the Board's custodial institution must hold short-term and long-term credit rating by at least one

Nationally Registered Statistical Ratings Organization (NRSRO) with a minimum requirement of A1/P1 (short-term) and A3/A-1 (long-term).

#### Cash

Custodial risk for cash is the risk that, in the event of the failure of the custodial financial institution, the cash or collateral securities may not be recovered from an outside party. The securities used as collateral are held by the Trustee in the name of the Board.

#### Investments

As of June 30<sup>th</sup>, Fund securities were recorded by the Trustee in the name of the Board by specific account.

#### CONCENTRATION OF CREDIT RISK

Concentration of credit risk is the risk of loss attributed to the magnitude of any single investment per issuer name. Investments directly issued or explicitly guaranteed by the U.S. government and investments in mutual funds are excluded from the concentration of credit risk requirement. The STIP Investment Policy Statement (IPS) limits concentration of credit risk by limiting portfolio investment types to 3% in any issuer except for U.S. Treasury and U.S. Agency securities as well as any repurchase agreements with a financial institution. STIP concentration risk was within the policy as set by the Board.

#### CREDIT RISK

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. The Fund's U.S. government direct-backed securities, consisting of U.S. Treasury notes and bills, are guaranteed directly by the U.S. government. Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. The Permitted Investments, as described in the Indenture, include "Either (i) long term obligations of such bank, trust company or association are rated in one of the three highest investment category of the Standard & Poor's Corporation or Moody's Investor Service Inc., which investment category shall not be less than the prevailing rate on the Bonds or (ii) the deposits are continuously secured as to principal, but only to the extent not insured by the Bank Insurance Fund or the Savings Association Insurance Fund, or any successor to either, of the Federal Deposit Insurance Corporation (FDIC)."

The Board's STIP IPS specifies that STIP securities have a minimum of two credit ratings as provided by national recognized statistical rating organizations to assist in the monitoring and management of credit risk. The purchase of STIP securities other than U.S. government or U.S. Agency obligations are restricted to those which are pre-approved. Although the STIP investments have been rated by investment security type, STIP, as an external investment pool, has not been rated.

#### INTEREST RATE RISK

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Permitted Investments as described in the Indenture details the allowable investments, including those in STIP. STIP interest rate risk is determined using the Weighted Average Maturity (WAM) method.

According to the STIP IPS, “The STIP portfolio will minimize interest rate risk by:

- 1) structuring the investment portfolio so securities mature to meet cash requirements for ongoing operations thereby normally avoiding the need to sell securities on the open market prior to maturity;
- 2) maintaining a dollar-weighted average portfolio maturity (WAM) of 60 days or less (for this purpose, the date to the next coupon reset date will be used for all floating or variable rate securities; and
- 3) STIP will maintain a reserve account.”

Fund investments are categorized as follows to disclose credit and interest rate risk as of June 30<sup>th</sup>. Credit risk reflects the weighted credit quality rating by investment type. Interest rate risk is disclosed using weighted effective duration as calculated by Board staff. The credit quality ratings have been calculated excluding non-rated investment types. Both the credit quality ratings and duration have been calculated excluding cash equivalents, as Management of the Board determined that these securities did not contain these risk elements. There were no derivative transactions during the fiscal year for investments held by the Trustee.

Credit Quality Rating and Effective Duration as of June 30, 2018 (in thousands)			
<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating (1)</u>	<u>Effective Duration (1)</u>
Short-term investments			
US Treasury Obligations	\$ 3,182	AA	0.24
US Agency Obligations	1,080	AA	0.63
Restricted investments			
US Treasury Obligations	685	AA	2.42
Total investments by fair value level	<u>\$ 4,947</u>		
1) Credit Quality Rating and Effective Duration are weighted.			

Based on their short weighted average maturity and the relative immaterial difference from their cost to fair value as of June 30<sup>th</sup>, the Board deemed the cash equivalents to have little discernible interest rate risk. In addition, the Board has not suffered a loss event on the cash equivalents as of June 30<sup>th</sup> as of the date of the auditors report.

#### FAIR VALUE MEASUREMENT

The Board categorizes its fair value measurements within the fair value hierarchy established by GAAP as follows:

Level 1— Quoted prices for identical assets or liabilities in active markets.

Level 2— Prices determined using inputs, other than quoted prices included within Level 1, that are observable for an asset or liability, either directly or indirectly.

Level 3 – Prices are determined using unobservable inputs.

Investments classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities.

Investments classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices.

For the Fund, the Board has the following fair value measurements as of June 30<sup>th</sup>:

Enterprise Fund Investments Measured at Fair Value (in thousands)		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable (Level 3)
	June 30, 2018			
<u>Investments by fair value level</u>				
Short-term investments at fair value				
US Treasury Obligations	\$ 3,182	\$ 3,182	\$ -	\$ -
US Agency Obligations	1,080	-	1,080	-
Restricted investments at fair value				
US Treasury Obligations	685	685	-	-
Total investments by fair value level	<u>\$ 4,947</u>	<u>\$ 3,867</u>	<u>\$ 1,080</u>	<u>\$ -</u>

#### 4. RECEIVABLES

Receivables related to the INTERCAP loan program were \$81.4 million and Other Receivables were \$263 thousand as of the fiscal year-end. The INTERCAP loan program loans money to local governments, state agencies (Interfund) and component units of the State. Amounts related to the notes/loan receivable identified in the Statement of Net Position, are detailed as follows:

Note/Loan Receivables For Year Ended June 30, 2018 (in thousands)				
	Local Government	Interfund	Component Unit	Total
Notes/Loans Receivable - ST	\$ 10,118	\$ 3,222	\$ 2,723	\$ 16,063
Notes/Loans Receivable - LT	38,692	5,555	20,736	64,983
Interest Receivable	557	93	270	920
	<u>\$ 49,367</u>	<u>\$ 8,870</u>	<u>\$ 23,729</u>	<u>\$ 81,966</u>

The interfund and component unit note/loan receivables are further broken down by fund type and component unit as follows:

Interfund / Component Unit Receivable by Fund Type / CU For Year Ended June 30, 2018 (in thousands)					
	<u>Interfund</u>		<u>Component Unit</u>		<u>Total</u>
	<u>Debt Service</u>	<u>Internal Service Fund</u>	<u>Montana</u>	<u>University of</u>	
			<u>State</u> <u>University</u>	<u>Montana</u>	
Interfund	\$ 2,880	\$ 5,897	\$ -	\$ -	\$ 8,777
Component Unit	-	-	10,021	13,438	23,459
Interest Receivable	85	8	117	153	363
	<u>\$ 2,965</u>	<u>\$ 5,905</u>	<u>\$ 10,138</u>	<u>\$ 13,591</u>	<u>\$ 32,599</u>

#### 5. BONDS PAYABLE

The Fund is authorized to issue INTERCAP bonds under the Municipal Finance Consolidation Act. These bonds may not aggregate more than \$190 million as amended by the 2007 Legislature. The INTERCAP bonds provide funds for the Board to make loans to eligible government units.

The bonds are not a debt or liability of the State. The bonds are limited obligations of the Board payable solely from: a) repayments of principal and interest on loans made by the Board to participating eligible Montana governments; b) investment income under the Indenture; and c) an irrevocable pledge by the Board. The Board has no taxing power. These bonds may be tendered at the bondholder's option or they may be redeemed at the Board's option, any March 1, prior to maturity. The Board did not enter into an arms-length financing agreement to convert the bonds "put," or tender, and were not resold into some other form of long-term obligation. Accordingly, these bonds, considered demand bonds, are recorded as current liabilities of the Fund.

Bonds Payable at June 30, 2018 (in thousands)				
<u>Series</u>	<u>Amount Issued</u>	<u>Interest Range</u>	<u>Maturity</u>	<u>Balance June 30, 2018</u>
2000	15,000	Variable	2025	14,255
2003	15,000	Variable	2028	14,330
2004	18,500	Variable	2029	18,000
2007	15,000	Variable	2032	14,695
2010	12,000	Variable	2035	11,900
2013	12,000	Variable	2038	11,970
2017	20,000	Variable	2042	19,960
Total INTERCAP Debt	<u>\$ 107,500</u>			<u>\$ 105,110</u>
Current Bonds Payable				<u>\$ 105,110</u>

The following schedule summarizes the INTERCAP activity during the fiscal year (in thousands):

<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>
\$ 107,880	\$ 0	\$ 2,770	\$ 105,110

#### BOND/LOAN GUARANTEES

As of June 30<sup>th</sup>, the Fund had received a nonexchange financial guarantee from the STIP, Coal Severance Tax Trust Fund, and the Treasurer's Cash Fund for exposure to INTERCAP bond issues in the amount of \$105.1 million. STIP is an external investment pool managed by the Board. Both the Coal Severance Tax Trust Fund and the Treasurer's Fund are part of the primary government for the State. The Board manages the Treasurer's Cash Fund which consists of fund balances of all the funds for the State whose investments earnings are permitted by law to flow to the State's General Fund. The nonexchange financial guarantee was extended through the Board's management of the Unified Investment Program. The Board has irrevocably pledged to make loans to cure INTERCAP reserve account deficiencies and to purchase tendered bonds not redeemed or remarketed. The outstanding bonds have final maturities of March 1, 2025 – March 1, 2042. The Board has not had to perform on any loan guarantee in the past.

By statute, the Board is authorized to credit enhance the INTERCAP bonds and charges a fee for this service. There is an annual fee of up to 15 basis points on outstanding INTERCAP bonds. If the Board was called on to purchase tendered bonds not redeemed or remarketed, INTERCAP's governing bond indenture requires the Board to be paid a fee equal to 25 basis points of the principal amount of tendered bonds actually purchased. The credit enhancement fee paid to the Board's Unified Investment Program during the fiscal year was \$162 thousand.

#### 6. CHANGES IN LONG-TERM DEBT

The fund long-term activities for the year ended June 30<sup>th</sup>, were as follows:

Changes in Long-Term Debt for year ended June 30, 2018 (in thousands)						
	Beginning Balance	Additions	Deductions	Ending Balance	Amounts Due Within One Year	Amounts Due in More Than One Year
Property Held in Trust	\$ -	\$ 2,165	\$ (311)	\$ 1,854	\$ -	\$ 1,854
Compensated Absences	63	62	(63)	62	33	29
Arbitrage Rebate Tax Payable	22	4	(9)	17	-	17
OPEB Implicit Rate Subsidy	89	19	(89)	19	-	19
Net Pension Liability	385	64	(30)	419	-	419
Total Long-term Liabilities	\$ 559	\$ 2,314	\$ (502)	\$ 2,371	\$ 33	\$ 2,338

#### 7. CONDUIT (NO COMMITMENT) DEBT

##### QZAB Debt

In this program, the Board is authorized to issue Qualified Zone Academy Bonds (QZAB), under the Municipal Finance Consolidation Act, as conduit (no commitment) debt. The revenues, and in some cases the taxing power, of the borrower are pledged to repay the bonds. Because the Board has no obligation for this debt, these bond issues are not reflected on the Board's financial statements. The borrower has set money aside to be used for the repayment of these bonds in accounts that are held in trust by the Board in the amount of \$1.854 million. Bonds issued and outstanding by the Board as QZAB conduit (no-commitment) debt are listed as follows:

QZAB Debt as of June 30, 2018 (in thousands)				
<u>Project</u>	<u>Issue Date</u>	<u>Maturity Date</u>	Amount <u>Issued</u>	Balance <u>June 30, 2018</u>
Cut Bank Elementary	August 2005	08/18/21	825	825
Cut Bank High School	August 2005	08/18/21	625	625
Kalispell Elementary	October 2013	06/15/28	620	620
Kalispell High School	October 2013	06/15/28	1,587	1,587
Anaconda Elementary	August 2017	06/15/32	658	658
Anaconda High School	August 2017	06/15/32	707	707
Total QZAB conduit debt			<u>\$ 5,022</u>	<u>\$ 5,022</u>

<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>
\$ 6,430	\$ 1,365	\$ 2,773	\$ 5,022

#### QSCB Debt

In this program, the Board is authorized to issue Qualified School Construction Bonds (QSCB), under the Municipal Finance Consolidation Act, as conduit (no commitment) debt. The revenues of the borrower are pledged to repay the bonds. Because the Board has no obligation for this debt, these bond issues are not reflected on the Board's financial statements. Bonds issued and outstanding by the Board as QSCB conduit (no-commitment) debt are as follows:

QSCB Debt as of June 30, 2018 (in thousands)				
<u>Project</u>	<u>Issue Date</u>	<u>Maturity Date</u>	Amount <u>Issued</u>	Balance <u>June 30, 2018</u>
Great Falls High Schools	April 2011	12/15/25	\$ 1,855	\$ 1,122
Great Falls Elementary	April 2011	12/15/25	6,510	3,938
Total QSCB conduit debt			<u>\$ 8,365</u>	<u>\$ 5,060</u>

<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>
\$ 5,608	\$ -	\$ 548	\$ 5,060

#### 8. INTERCAP PROGRAM COMMITMENTS

The Board makes firm commitments to fund loans from the INTERCAP loan program. The Board's outstanding commitments to eligible Montana governments, as of June 30<sup>th</sup>, totaled \$38 million.

#### 9. PENSIONS

##### PLAN DESCRIPTION

The Board and its employees contribute to either the Public Employees' Retirement System (PERS)-Defined Benefit Retirement Plan (DBRP) or the PERS-Defined Contribution Retirement Plan (DCRP). Both the DBRP and the DCRP are administered by the Montana Public Employee Retirement Administration (MPERA). The DBRP is a multiple-employer, cost-sharing plan and the DCRP is a multiple-employer plan. Both the DBRP and DCRP provides retirement, disability, and death benefits to plan members and their beneficiaries.

All new members are initially members of the PERS-DBRP and have a 12-month window during which they may choose to remain in the PERS-DBRP or join the PERS-DCRP by filing an irrevocable election. Members may not be members of both the defined contribution and defined benefit retirement plans.

Benefits are established by state law and can only be amended by the Legislature. Benefits are dependent upon eligibility. PERS-DCRP benefits are also based on individual account balances. Member rights are immediately vested in their own contributions and attributable income. Members are vested after five years of service for the employer's contributions to individual accounts and the attributable income. Non-vested contributions are forfeited upon termination of employment per statute. Forfeitures are used to cover the administrative expenses of the DCRP. At the plan level, the DCRP employer did not recognize any Net Pension Liability (NPL) or pension expense. For the year ended June 30, 2018, plan level non-vested forfeitures for the 300 employers that have participants in the PERS-DCRP totaled \$397 thousand.

Employees of the fund may or may not be members of the DCRP. Based on confidentiality requirements, PERS is not able to provide detail on DCRP members. The pension liability, pension deferred inflows and pension deferred outflows as reported within these financial statements related to DBRP members. The pension disclosure as follows applies to both DBRP and DCRP, unless specifically stated otherwise.

The PERS financial information is reported in the Montana Public Employees Retirement Board (MPERB) Comprehensive Annual Financial Report (CAFR). MPERB's CAFR information including PERS stand-alone financial statements and latest actuarial valuation reports can be found on MPERA's web site at <http://mpera.mt.gov/index.shtml>; at 100 North Park, PO Box 200131, Helena MT 59620-0131; or at 406-444-3154. The information contained within MPERB's CAFR will only display information regarding PERS in total and will not display information specific to the Fund as an entity. The Fund activity is reported within the Department of Commerce GASB 68 employer report as prepared by MPERA and represents 2.62% of the agency's liability and .02% of the total liability for all employers for the fiscal year.

#### Net Pension Liability (NPL)

At year end, the Fund recorded a liability of \$419 thousand for its 2.6% proportionate share of the DBRP NPL and \$51 thousand for its proportionate share of the pension expense. The employer's proportionate share equals the ratio of the employer's contributions to the sum of all employer and non-employer contributions during the measurement period.

#### SUMMARY OF BENEFITS - DBRP

##### Member's highest average compensation (HAC)

Hired prior to July 1, 2011	HAC during any consecutive 36 months;
Hired on or after July 1, 2011	HAC during any consecutive 60 months;
Hired on or after July 1, 2013	110% annual cap on compensation considered as part of a member's HAC.

##### Compensation Cap

Hired on or after July 1, 2013	110% annual cap on compensation considered as part of a member's HAC.
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##### Vesting

5 years of membership service

##### Eligibility for benefit

##### Service retirement:

Hired prior to July 1, 2011	Age 60, 5 years of membership service; Age 65, regardless of membership service; or Any age, 30 years of membership service.
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Hired on or after July 1, 2011	Age 65, 5 years of membership service; Age 70, regardless of membership service.
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*Early retirement, actuarially reduced:*

Hired prior to July 1, 2011	Age 50, 5 years of membership service; or Any age, 25 years of membership service.
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Hired on or after July 1, 2011      Age 55, 5 years of membership service.

**Second Retirement** (requires returning to PERS covered employment or PERS service)

*Retire before January 1, 2016 and accumulate less than 2 years additional service credit, or*

*Retire on or after January 1, 2016 and accumulate less than 5 years additional service credit:*

- A refund of member's contributions plus regular interest (.25%);
- No service credit for second employment;
- Start the same benefit amount the month following termination; and
- GABA start again in the January immediately following the second retirement.

*Retire before January 1, 2016 and accumulate at least 2 years of additional service credit:*

- A recalculated retirement benefit based on provisions in effect after the initial retirement; and
- GABA starts on the recalculated benefit in the January after receiving the new benefit for 12 months.

*Retire on or after January 1, 2016 and accumulate 5 or more years of service credit:*

- The same retirement as prior to the return to service;
- A second retirement benefit as prior to the second period of service based on laws in effect upon the rehire date; and
- GABA starts on both benefits in the January after receiving the original and the new benefit for 12 months.

### Monthly benefit formula

Members hired prior to July 1, 2011

- Less than 25 years of membership service: 1.785% of HAC per year of service credit;
- 25 years of membership service or more: 2% of HAC per year of service credit.

Members hired on or after July 1, 2011

- Less than 10 years of membership service: 1.5% of HAC per year of service credit;
- 10 years or more, but less than 30 years of membership service: 1.785% of HAC per year of service credit;
- 30 years or more of membership service: 2% of HAC per year of service credit.

### Guaranteed Annual Benefit Adjustment (GABA)

After the member has completed 12 full months of retirement, the member's benefit increases by the applicable percentage each January, inclusive of other adjustments to the member's benefit.

- 3.0% for members hired prior to July 1, 2007
- 1.5% for members hired between July 1, 2007 and June 30, 2013
- Members hired on or after July 1, 2013:
  - 1.5% for each year PERS is funded at or above 90%;
  - 1.5% is reduced by 0.1% for each 2.0% PERS is funded below 90%; and
  - 0.0% whenever the amortization period for PERS is 40 years or more

## OVERVIEW OF CONTRIBUTIONS

Rates are specified by state law for periodic employer and employee contributions. The State legislature has the authority to establish and amend the statutory contribution rates to the plan.

Currently, plan members are required to contribute 7.90% of members' compensation. Contributions are deducted from each member's salary and remitted by participating employers. By statute, the members' 7.90% contributions are temporary and will be decreased to 6.90% on January 1 following actuary valuation results that show the amortization period has dropped below 25 years and would remain below 25 years following the reduction of both the additional employer and additional member contribution rates.

As the employer, the State was required to contribute 8.57% of members' compensation for the fiscal year. Beginning July 1, 2014, the employer contributions will increase an additional 0.1% a year over 10 years, through 2024. The employer additional contributions including the 0.27% added in 2007 and 2009, terminates on January 1 following actuary valuation results that show the amortization period of the PERS-DBRP has dropped below 25 years and would remain below 25 years following the reductions of both the additional employer and member contributions rates. The additional contributions were not terminated on January 1, 2018. Effective July 1, 2013, employers are required to make contributions on working retirees' compensation. Member contributions for working retirees are not required. DBRP received non-employer contributions from the Coal Severance Tax income and earnings from the Coal Trust Permanent Trust fund. Per statute, state agencies are required to pay their own additional contributions as employer contributions.

PERS received 100% of the required contributions from the Fund in the amount of \$22 thousand for the fiscal year.

#### ACTUARIAL ASSUMPTIONS - DBRP

The Total Pension Liability (TPL) used to calculate the NPL as of the fiscal year, is based on the results of an actuarial valuation date of June 30, 2016, and applying standard roll forward procedures to update the TPL to June 30, 2017. There were several significant assumptions and other inputs used to measure the TPL. The actuarial assumptions used in the June 30, 2017 valuation were based on the results of the last actuarial experience study, dated May 2017 for the six-year period July 1, 2010 to June 30, 2016. Among those assumptions were the following:

- Investment Return (net of admin expense) 7.65%
- Admin Expense as a % of Payroll 0.26%
- General Wage Growth\* 3.50%
  - \*includes inflation at 2.75%
- Merit Increases 0.00% to 4.80%
- Guaranteed Annual Benefit Adjustment (GABA)
  - After the member has completed 12 full months of retirement, the member's benefit increases by the applicable percentage each January, inclusive of other adjustments to the member's benefit.
    - 3.0% for members hired prior to July 1, 2007
    - 1.5% for members hired between July 1, 2007 and June 30, 2013
    - Members hired on or after July 1, 2013:
      - 1.5% for each year PERS is funded at or above 90%;
      - 1.5% is reduced by 0.1% for each 2.0% PERS is funded below 90%; and
      - 0% whenever the amortization period for PERS is 40 years or more.
- Mortality assumptions among contributing members, terminated vested members, service retired members and beneficiaries based on RP 2000 Combined Employee and Annuitant Mortality Tables projected to 2020 with scale BB, males set back 1 year.
- Mortality assumptions among Disabled Retirees are based on RP 2000 Combined Employee and Annuitant Mortality Tables with no projections.

CHANGES IN ACTUARIAL ASSUMPTIONS AND METHODS

Effective July 1, 2017, the following assumption changes were used:

- Lowered the interest rate from 7.75% to 7.65%
- Lowered the inflation rate from 3.00% to 2.75%
- Updated non-disabled mortality to the RP-2000 Combined Employee and Annuitant Mortality Table
- Increased rates of withdrawal
- Lowered the merit component of the total salary increase
- Lowered the wage base component of the total salary increase from 4.00% to 3.50%
- Decreased the administrative expense load from .27% to .26%

Effective July 1, 2017, the following method changes were used:

- Administrative expenses are recognized by an additional amount added to the normal cost contribution rate for the System. This amount will vary from year to year based on the prior year's actual administrative expenses.
- To be consistent with the wage base growth change, the payroll growth assumption for amortization as a level percent of pay was reduced from 4.00% to 3.50%.

Changes in benefit terms:

Effective July 1, 2017, the following benefit changes were made:

- The interest rate credited to member accounts increased from .25% to .77%
- Lump sum payouts in all systems are limited to the member's accumulated contributions rather than the present value of the member's benefit

Changes in proportionate share:

Between the measurement date of the collective NPL and the employer's reporting date there were no changes in proportion that would have an effect on the employer's proportionate share of the collective NPL.

DISCOUNT RATE - DBRP

The discount rate used to measure the Total Pension Liability was 7.65%. The projection of cash flows used to determine the discount rate assumed that contributions from participating plan members, employers, and non-employer contributing entities will be made based on the Board's funding policy, which establishes the contractually required rates under Montana Code Annotated. The State contributes 0.1% of salaries for local governments and 0.37% for school districts. In addition, the State contributes coal severance tax and interest money from the general fund. The interest is contributed monthly and the severance tax is contributed quarterly.

Based on those assumptions, the System's fiduciary net position was projected to be adequate to make all the projected future benefit payments of current plan members through the year 2121. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the TPL. A municipal bond rate was not incorporated in the discount rate.

TARGET ALLOCATIONS - DBRP

The long-term expected return on pension plan assets is reviewed as part of the regular experience study prepared for the System. The most recent analysis, performed for the period July 1, 2010 to June 30, 2016, was outlined in a report dated May 2017, which is located on the MPERA website. The long-term expected rate of return on pension plan investments was determined by considering information from various sources, including historical rates of return, rate of return assumptions adopted by similar public-sector systems, and by using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges were combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of arithmetic real rates of return for each major asset class included in the target asset allocation as of June 30, 2017 are summarized as follows:

Asset Class	Target Asset Allocation	Long-Term Expected Real Rate of Return Arithmetic Basis
	(a)	(b)
Cash Equivalents	2.6%	4.00%
Domestic Equity	36.0%	4.55%
Foreign Equity	18.0%	6.35%
Fixed Income	23.4%	1.00%
Private Equity	12.0%	7.75%
Real Estate	<u>8.0%</u>	4.00%
Total	100.0%	

#### SENSITIVITY ANALYSIS - DBRP

The table as follows represents the employer NPL calculated using the discount rate of 7.65%, as well as what the NPL would be if it were calculated using a discount rate that is 1.00% lower (6.65%) or 1.00% higher (8.65%) than the current rate (in thousands).

Net Pension Liability Sensitivity Analysis	1.0% Decrease (6.65%)	Current Discount Rate (7.65%)	1.0% Increase (8.65%)
Enterprise Fund	\$ 606	\$ 419	\$ 256

#### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - DBRP

DBRP financial statements are prepared using the accrual basis of accounting. The same accrual basis was used for the purposes of measuring the NPL, deferred inflows of resources and deferred outflows of resources related to pensions, pension expense, the fiduciary net position and additions to/deductions from fiduciary net position. Member contributions are recognized in the period in which contributions are due. Employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Revenues are recognized in the accounting period they are earned and become measurable. Benefit payments and refunds are recognized in the accounting period when due and payable in accordance with the benefit terms. Expenses are recognized in the period incurred. Investments are reported at fair value. MPERA adhered to all accounting principles generally accepted by the United States of America and applied all applicable pronouncements of the Governmental Accounting Standards Board (GASB).

PERS has a special funding situation in which the State, as a non-employer contributing entity, is legally responsible for making contributions directly to PERS on behalf of local government, school district and other governmental agency employers.

The State, as a non-employer contributing entity, also paid to the Plan coal tax contributions that are not accounted for a special fund for all participating employers. Contributions provided by the Coal Tax revenue attributable to the Fund was \$6 thousand.

#### DEFERRED PENSION INFLOW / OUTFLOW - DBRP

At year end, the employer recognized a deferred outflow of resources of \$68 thousand for expected versus actual experience and changes in assumptions. The pension deferred inflows were \$15 thousand, which related to the net difference between projected and actual earning on pension plan investments.

Amounts reported as deferred outflows of resources related to pensions resulting from the employer's contributions subsequent to the measurement date will be recognized as a reduction of the NPL in the year ended June 30, 2018. Other amounts reported as deferred outflows and inflows of resources related to pensions will be recognized in Pension Expense as follows (in thousands):

For the Measurement Year ended June 30:	Recognition of Deferred Outflows/Inflows in future years as an increase/(decrease) to pension expense
2018	\$ 15
2019	33
2020	25
2021	(9)
2022	0
Thereafter	0

#### 10. OTHER POST EMPLOYMENT BENEFITS (OPEB)

##### GENERAL INFORMATION ABOUT THE STATE EMPLOYEE GROUP BENEFITS (SEGB) OPEB PLAN

*Plan description.* The Board's defined benefit OPEB plan, the SEGB, provides optional OPEB in accordance with Section 2-18-704, MCA. This coverage applies to the following employees and dependents who elect to continue coverage and pay administratively established contributions: 1) employees and dependents who retire under applicable retirement provisions and 2) surviving dependents of deceased employees. The SEGB OPEB plan is a single-employer defined benefit OPEB plan administered by statute by the Montana Department of Administration Health Care and Benefits Division (HCBD). The Fund is reported within the primary government for reporting purposes.

SEGB is not administered through a trust. It is administered through an arrangement in which contributions to the OPEB plan and earnings on those contributions are irrevocable. The OPEB plan assets provide OPEB to plan members in accordance with benefit terms. There are no assets accumulated to offset the total OPEB liability. The State funds the benefits on a pay-as-you-go basis from general assets.

The healthcare OPEB plan allows retirees to participate, as a group, at a rate that does not cover all the related costs. This results in the reporting of an 'implied rate' subsidy in the related financial statements and note disclosures.

*Benefits provided.* A retiree may continue coverage with the SEGB if the retiree is eligible to receive a monthly retirement benefit under their particular retirement system at the time of leaving active employment and elect to start medical coverage within 60 days of leaving employment. The Board's employees retire under either the PERS-DBRP or the PERS-DCRP retirement plans.

Non-Medicare retirees may continue the core plan, which includes medical, dental and basic life insurance. Vision coverage is optional. Medical, dental and vision coverage is optional for dependents. Medicare eligible retirees may continue medical coverage. Dental and vision coverage is optional, and no life insurance is available. Medical, dental and vision coverage is optional for dependents. Medicare eligible retirees must enroll in both Part A and Part B Medicare coverage.

A retiree may continue coverage for a spouse who does not work for the State. If coverage is not continued, the spouse may only be added when the spouse loses eligibility for other coverage. If the retiree and spouse both work for the State, the retiree may elect to be covered under the working spouse and retains the right to exercise the transfer option. Dependent medical or dental coverage can only be continued if the retiree continues medical and/or dental coverage.

A surviving spouse may elect to continue their medical, dental, or vision coverage until Medicare age, at which time they will be offered COBRA and no longer be eligible for the plan. For surviving spouses already of Medicare age, they will be offered COBRA and lose eligibility under the plan at the end of the offering month.

*Retiree Premiums.* DOA established retiree premiums vary depending on family coverage and eligibility. Per statute, retirees are responsible for their premiums and State agencies do not contribute an employer's share. The administratively established retiree medical contributions vary between \$439 and \$1,633 per month depending on coverage selected. Administratively established dental contributions vary between \$41.10 and \$70, monthly, and vision hardware contributions vary between \$7.64 and \$22.26, monthly, depending on coverage selected.

#### TOTAL OPEB LIABILITY

The Board's total OPEB liability of \$19 thousand which is approximately 0.04% of the total primary government OPEB liability of \$49.473 million as measured on March 31, 2018 as a basis of the total group insurance premiums paid. The total OPEB liability used to calculate the total OPEB liability was determined by an actuarial valuation as December 31, 2017 with a rolled forward actuarial valuation measurement date of March 31, 2018.

*Actuarial assumptions.* The total OPEB liability in the actuarial valuation was determined using the following actuarial assumptions, applied to all periods included in the measurement, unless otherwise specified:

Actuarial valuation date	December 31, 2017, rolled forward to March 31, 2018
Interest/discount rate	3.89%
Projected payroll increases	4.00%
Actuarial funding method	Entry age normal
Amortization method	Level percentage of payroll on an open basis
Asset valuation	Not applicable since no assets meet the definition of plan assets
Average retirement age	61.88 years
Participation (of future retirees)	55% future retirees and 60% of future eligible spouses
Marital status	Actual spouse information is used for current retirees. Marital status at retirement for future members assumed to be 70%.
Mortality - Healthy	Assumed to follow RP2000 Combined Mortality Table with improvements projected by Scale BB to 2020, set back one year for males.
Mortality – Disabled	Assumed to follow the RP2000 Combined Mortality Table with no projections.
Healthcare cost trend rates	7.5% for both medical and prescription initially, decreasing 0.5% per year until 2021, and thereafter decreasing 0.1% or 0.2% per year to an ultimate rate of 3.8% in 2075. Cost increases are assumed to apply at the end of the plan year.
Retiree Contribution Increases	Current year was based on actual trend. For retiree/surviving spouse and spouse the increase is to 7.0% in 2019 decreasing 0.5% per year until 2021, and thereafter decreasing 0.1% or 0.2% per year to an ultimate rate of 3.8% in 2075 with the rate of 5.2% used for years 2027 – 2043 prior to again decreasing thereafter. .

- Changes since prior valuation:
  - o Revised rates per the retirement system pension valuation as of July 1, 2017
  - o Interest rate based on the March 31, 2018 20-year municipal bond index per GASB 75 requirements
  - o Revised rates based on actual data and projected trends
  - o Updated projected healthcare trend rates to follow the Getzen model
- Changes in benefit terms since last measurement date:
  - o State implemented reference-based pricing hospital contracts effective July 1, 2016
  - o The medical plan moved from Cigna to Allegiance plans as of January 1, 2016

- Pharmacy coverage moved from URx to Navitus as of January 1, 2017
  - State implemented an employer group waiver program for Medicare retirees effective January 1, 2017
- Retiree Contributions. The following retiree contributions are a weighted average of all retiree contributions for the period January 1, 2017 to December 31, 2017:

<u>Medical and Prescription Drug</u>	<u>Retiree/Surviving Spouse</u>	<u>Spouse</u>
Before Medicare Eligibility	\$13,572	\$5,268
After Medicare Eligibility	\$5,271	\$4,403

*Sensitivity of the total OPEB liability to changes in the discount rate.* The following presents the total OPEB liability of the Board, as well as what the Board's total OPEB liability would be if it were calculated using a discount rate that is 1-percentage-point lower (DR-1 percent) or 1-percentage-point higher (DR+1 percent) than the current discount rate (in thousands):

	1% Decrease (2.89%)	Discount Rate (3.89%)	1% Increase (4.89%)
Total OPEB liability (asset)	\$23	\$19	\$15

*Sensitivity of the total OPEB liability to changes in the healthcare cost trend rates.* The following presents the total OPEB liability of the Board, as well as what the Board's total OPEB liability would be if it were calculated using healthcare cost trend rates that are 1-percentage-point lower or 1-percentage-point higher than the current healthcare cost trend rates (in thousands):

Healthcare Cost Trend Rates			
	1% Decrease (6.5% decreasing to an ultimate rate of 2.8%)	(7.5% decreasing to an ultimate rate of 3.8%)	1% Increase (8.5% decreasing to an ultimate rate of 4.8%)
Total OPEB liability (asset)	\$15	\$19	\$23

#### OPEB EXPENSE AND DEFERRED OUTFLOWS OF RESOURCES AND DEFERRED INFLOWS OF RESOURCES RELATED TO OPEB

For the year ended June 30, 2018, the Board recognized OPEB expense of \$1 thousand. At June 30, 2018, the Board reported deferred outflows of resources and deferred inflows of resources related to OPEB from the following sources (in thousands):

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual experience	\$-	\$2
Total	\$-	\$2

Amounts reported as deferred outflows of resources and deferred inflows of resources related to OPEB will be recognized in OPEB expense as less than \$1 thousand for each year during 2019 – 2023 and at \$1 thousand thereafter.

#### PAYABLE TO THE OPEB PLAN

At June 30, 2018, the Board reported a payable of \$1 thousand for the outstanding amount of contributions to DOA



required for the year ended June 30, 2018.

#### GENERAL INFORMATION ABOUT THE DCRP OPEB PLAN

Per statute, participants that choose the PERS-DCRP retirement system are covered by the PERS-DCRP long-term disability plan. The disability plan provides disability benefits to plan members who are vested in the plan and are currently ineligible for retirement. A separate trust has been established for purposes of providing disability benefits to members. The assets are held in a trust capacity for the beneficiaries. The PERS issues publicly available annual reports which include financial statements and required supplemental information for the plan. Those reports may be obtained online (<http://mpera.mt.gov>) or by contacting the PERS at 100 North Park, Suite 200, PO Box 200131, Helena, MT 5620-0131.

### 11. NON-PENSION EMPLOYEE BENEFITS PLANS

#### DEFERRED COMPENSATION PLAN

The Board's permanent employees are eligible to participate in the State's deferred compensation plan. The compensation deferred is not available to employees until separation from State service, retirement, death, or upon an unforeseeable emergency, when still employed and meeting IRS specified criteria. The plan is governed by Internal Revenue Service Code (IRC) Section 457 and Title 19, Chapter 50, Montana Code Annotated (MCA). Assets of the deferred compensation plan are required to be held in trust, custodial accounts or insurance company contracts for the exclusive benefit of participants and their beneficiaries.

#### HEALTH CARE

Board staff and dependents are eligible to receive medical and dental health care through the State Group Benefits Plan administered by the Montana Department of Administration (DOA) Health Care & Benefits Division. The State funds claims on a pay-as-you-go basis. Montana DOA established premiums vary depending on family coverage and eligibility. Agencies contribute \$1,054 per month per eligible State employee, in addition to the employee's monthly contribution, as shown as follows for the calendar year (CY):

Premiums	CY17 and CY18
Medical	\$30.00 - \$327.00
Dental (optional)	\$0.00 - \$28.90
Vision Hardware (optional)	\$7.64 - \$22.26

### 12. SUBSEQUENT EVENTS

The Board's Executive Director retired September 28, 2018 and a new Executive Director started September 29, 2018. The Board's Deputy Executive Director retired November 23, 2018.

Since June 30, 2018, the Board made additional commitments to fund loans from the INTERCAP loan program in the amount of \$5.9 million.



**REQUIRED SUPPLEMENTARY INFORMATION (RSI)**



## PENSION LIABILITY AS AN EMPLOYER ENTITY

RSI regarding the pension information is as follows. As additional years of data are available, a total of 10 years will be presented. For further detail, see Note 9 - Pensions.

Schedule of RSI Schedule of Net Pension Liability (in thousands except percentages)				
	June 30, 2018	June 30, 2017	June 30, 2016	June 30, 2015
Proportion of NPL	.02%	.03%	.02%	.02%
Proportionate share of NPL	\$ 419	\$ 385	\$ 291	\$ 245
Pensionable payroll	\$ 262	\$ 307	\$ 241	\$ 220
Proportionate share of NPL as % of pensionable payroll	158.88%	143.92%	121.24%	111.22%
Plan fiduciary net position as % of total NPL	73.75%	74.71%	78.40%	79.87%

Schedule of RSI Schedule of Contributions (in thousands except percentages)				
	June 30, 2018	June 30, 2017	June 30, 2016	June 30, 2015
Contractually required contribution	\$ 22	\$ 51	\$ 21	\$ 19
Contributions made	(22)	(51)	(21)	(19)
Contribution deficiency / (excess)	0	0	0	0
Share of pensionable payroll	\$ 262	\$ 307	\$ 241	\$ 220
Contributions as a % of pensionable payroll	8.39%	8.47%	8.77%	8.83%

Changes in Actuarial Assumptions and Methods

Effective July 1, 2017, the following assumption changes were used:

- Lowered the interest rate from 7.75% to 7.65%
- Lowered the inflation rate from 3.00% to 2.75%
- Updated non-disabled mortality to the RP-2000 Combined Employee and Annuitant Mortality Table
- Increased rates of withdrawal
- Lowered the merit component of the total salary increase
- Lowered the wage base component of the total salary increase from 4.00% to 3.50%
- Decreased the administrative expense load from .27% to .26%

Effective July 1, 2017, the following method changes were used:

- Administrative expenses are recognized by an additional amount added to the normal cost contribution rate for the System. This amount will vary from year to year based on the prior year's actual administrative expenses.
- To be consistent with the wage base growth change, the payroll growth assumption for amortization as a level percent of pay was reduced from 4.00% to 3.50%.

Changes in benefit terms:

Effective July 1, 2017, the following benefit changes were made:

- The interest rate credited to member accounts increased from .25% to .77%
- Lump sum payouts in all systems are limited to the member's accumulated contributions rather than the present value of the member's benefit

Changes in proportionate share:

Between the measurement date of the collective NPL and the employer's reporting date there were no changes in proportion that would have an effect on the employer's proportionate share of the collective NPL.

OTHER POSTEMPLOYMENT BENEFITS PLAN INFORMATION (OPEB)

Retirees are allowed to participate, as a group, at a rate that does not cover all of the related costs. This results in the reporting of an 'implied rate' subsidy in the related financial statements and footnotes. As additional data are available, a total of 10 years will be presented. For further detail, see Note 10 – OPEB.

Schedule of Total OPEB Liability As of June 30, 2018 (in thousands except percentages)	
Proportion of Total OPEB liability	0.04%
Proportionate share of Total OPEB liability	\$19
Covered employee payroll	\$253
Total OPEB liability as a percentage of covered payroll	7.47%

Notes to Schedule:

No assets are set aside to fund the OPEB benefits. The State funds the benefits on a pay-as-you-go basis from general assets.

Factors the significantly affect trends in the amounts reported:

*Changes of benefit terms.* The medical plan moved from Cigna to Allegiance plans as of January 1, 2016, the State implemented reference-based pricing hospital contracts effective July 1, 2016, the pharmacy coverage moved from URx to Navitus as of January 1, 2017, and the State implemented an employer group waiver program for Medicare retirees effective January 1, 2017.

# **Report on Internal Control and Compliance**



# LEGISLATIVE AUDIT DIVISION

B-1

Angus Maciver, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors  
Cindy Jorgenson  
Joe Murray

## REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements the Unified Investment Program (UIP) and the Enterprise Fund Program financial statements of the Montana Board of Investments (board), as listed on the table of contents on page i, as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the board's financial statements, and have issued our reports thereon dated December 7, 2018.

### *Internal Control Over Financial Reporting*

In planning and performing our audits of the financial statements, we considered the board's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the board's internal control. Accordingly, we do not express an opinion on the effectiveness of the board's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described below, we identified certain deficiencies in internal control that we consider to be a material weakness and a significant deficiency.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

We consider the deficiency over the Enterprise Fund Program Statement of Cash Flow reporting, described on page 7, to be a material weakness.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit the attention by those charged with governance. We consider the deficiency over the completeness of UIP and Enterprise Fund note disclosures, described on page 8, to be a significant deficiency.

#### *Compliance and Other Matters*

As part of obtaining reasonable assurance about whether the board's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

#### *Montana Board of Investments' Response to Findings*

The Montana Board of Investments' response to the finding identified in our audit are described on page C-1 of this report. The board's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

#### *Purpose of this Report*

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the board's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the board's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA  
Deputy Legislative Auditor  
Helena, MT

December 7, 2018



MONTANA BOARD OF  
INVESTMENTS

BOARD RESPONSE



# MONTANA BOARD OF INVESTMENTS

Department of Commerce

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December 18, 2018

Angus Maciver, Legislative Auditor  
Legislative Audit Division  
Room 160, State Capitol  
PO Box 201705  
Helena, MT 59620-1705

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**LEGISLATIVE AUDIT DIV.**

Dear Mr. Maciver,

I am in receipt of the Financial-Compliance Audit dated December 2018 for the two fiscal years ending June 30, 2018, issued by the Legislative Audit Division. The audit report includes one recommendation requiring a response which is as follows:

**Recommendation #1**

*We recommend the Montana Board of Investments enhance internal controls over financial reporting to ensure staff consider and apply all relevant generally accepted accounting principles when implementing changes with a financial reporting impact.*

**Concur.** The Board will continue to enhance internal controls over financial reporting.

The Board does, however, disagree with the "material weakness" finding relating to the Statement of Cash Flows. The Board feels this finding would more appropriately be classified as a significant deficiency as it does not, in our and our consultant's opinion, present a "reasonable possibility that a material misstatement of [our] financial statements" would occur, fail to be detected, or be remedied.

The Board appreciates the recognition by your staff auditors, particularly the on-site team of Karen Simpson and Katie Majerus, of the continued improvements made to our financial reporting.

Sincerely,

DAN VILLA  
Executive Director